In the Supreme Court of the United States

OCTOBER TERM, 1943.

FEDERAL POWER COMMISSION, CITY OF AKRON, AND PENNSYLVANIA PUBLIC UTILITY COMMISSION, PETITIONERS,

vs.

HOPE NATURAL GAS COMPANY.

No. 34

CITY OF CLEVELAND,

Petitioner,

vs.

HOPE NATURAL GAS COMPANY,

Respondent.

No. 35

On Writs of Certiorari to the United States Circuit Court of Appeals for the Fourth Circuit.

BRIEF ON BEHALF OF HOPE NATURAL GAS COMPANY.

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CITY OF CLEVELAND, *Petitioner,* vs. HOPE NATURAL GAS COMPANY, *Respondent.*	**No. 35**

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT.

BRIEF ON BEHALF OF HOPE NATURAL GAS COMPANY.

Both of the above cases arise out of the same proceedings below and we therefore file one brief.

OPINIONS BELOW.

The opinion of the Circuit Court of Appeals for the Fourth Circuit (R. IV, 169-207[1]) is officially reported in 134 F. (2d) 287. The opinion of the Federal Power Commission (R. I, 16-89) is reported in 44 P. U. R. (N. S.) 1.

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[1] In the record citations, roman numerals refer to the volume and arabic numerals to the page.

JURISDICTION.

The judgment of the Circuit Court of Appeals was entered on February 16, 1943 (R. IV, 207). The petitions for a writ of certiorari were filed on April 6, 1943, and were granted on May 17, 1943 (R. IV, 209, 210). The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925 (28 U. S. C. § 347), and Section 19(b) of the Natural Gas Act (15 U. S. C. § 717r).

QUESTIONS PRESENTED.

(Com. Brief, 2-4; Cleve. Brief, 7-8)[2]

There are only two ultimate questions in this case. The first is whether the court below properly set aside the reduced rates prescribed by the Commission's findings and order because they are "too low" (*Federal Power Commission v. Natural Gas Pipeline Company of America*, 315 U. S. 575, 585). The second is whether the court below also properly set aside the Commission's retroactive findings as to the lawfulness of past rates because they are not "within the ambit" of the Commission's statutory authority (315 U. S., 586). These two questions are stated by the petitioners as Nos. 7, 8 and 9.

All other questions are subsidiary to the first. Whether the rates are too low depends upon a proper determination of rate base, operating expenses and rate of return. Petitioners state some of these subsidiary issues in their questions Nos. 1 through 6, but only those as to which they believe the court below erred.

The court below properly set aside the Commission's rate action if "as applied to the facts before it and viewed in its entirety" it produced an "arbitrary result" (315 U.

[2] These abbreviations refer to the Brief for Petitioners in No. 34 and the Brief of Petitioner in No. 35, respectively. The references thereto under the headings of this brief show where the petitioners discuss the respective subjects here discussed.

S., 586). Accordingly it is necessary to discuss, as we do in this brief, not only the subsidiary questions mentioned by the petitioners, but also the several determinations by the court below supporting its final judgment which are not here challenged by the petitioners and the several other important grounds upon which that judgment can properly rest.

We can not accept the statement in the Commission's brief (p. 2) that the Commission used a "prudent investment" rate base and the resulting implication that it used a prudent investment method of rate making. As we point out in this brief, it used a rate base and method of rate making which viewed in their entirety are arbitrary and unreasonable and produced too low a rate whether tested by the fair value method, or by the prudent investment method, or by any other general standard of reasonableness.

STATEMENT.

(Com. Brief, 4-15; Cleve. Brief, 9-19)

We supplement the statements made in the petitioners' briefs as follows:

1. Hope's Business and Properties.

Hope was organized in 1898 under West Virginia laws. Its business is now, and always its principal business has been, the production, purchase, transmission and marketing of natural gas in that state (Ex. 4, R. I, 107-111). The division of its annual sales between local sales in West Virginia and sales of gas exported from West Virginia is indicated in the following table in thousands of cubic feet, abbreviated as M.c.f. (Ex. 2, 2; Ex. 2B, 3[3]):

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[3] In accordance with Rule 10 of the Circuit Court of Appeals for the Fourth Circuit the parties below printed as supplements or appendices to their briefs only such parts of the record as they

(Continued on next page)

Hope's Annual Gas Sales—M.c.f.

	1937	1938	1939	1940*
Total Local Sales of Gas in West Virginia	11,428,353	8,632,673	9,732,983	11,320,325
Export Gas Sales:				
To East Ohio	35,074,416	30,316,773	33,907,672	40,376,091
To Peoples	3,506,013	2,870,545	3,864,104	9,738,612
To River	330,644	222,615	237,640	391,859
To Fayette	849,305	837,986	840,398	859,106
To Manufacturers	4,523,967	3,995,563	2,500,755	2,241,684
Total Export Gas Sales	44,284,345	38,243,482	41,350,569	53,607,352
Total Gas Sales	55,712,698	46,876,155	51,083,552	64,927,677

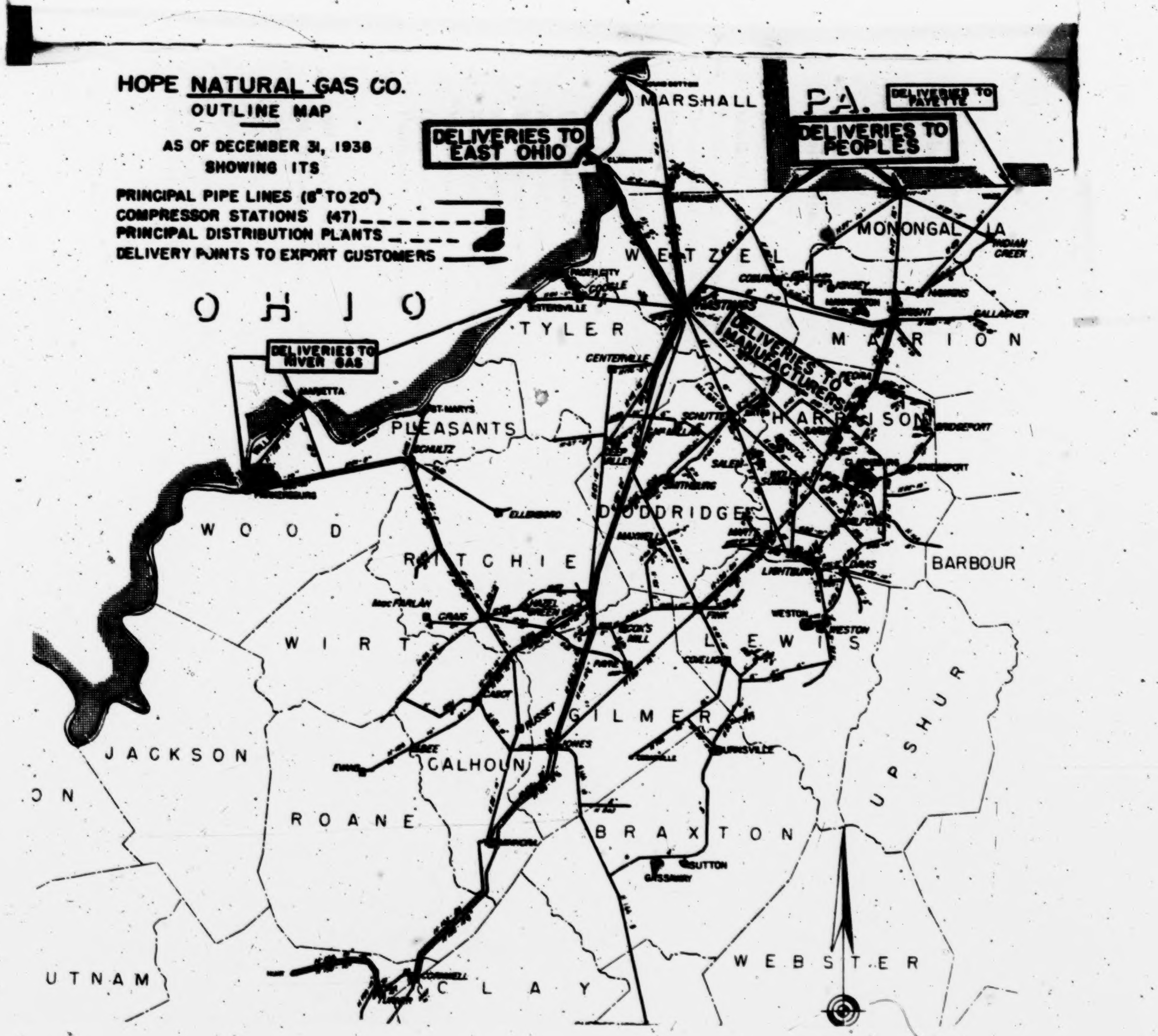
* Excluding sales from former Reserve Gas Company properties, see *infra*, p. 19.

All five of the export customer companies receive delivery of gas at or near the northern West Virginia state line. The East Ohio Gas Company, The Peoples Natural Gas Company and The River Gas Company, like Hope, are subsidiaries of Standard Oil Company (New Jersey). Fayette County Gas Company and The Manufacturers Light and Heat Company are not. The names of these companies are hereinafter abbreviated as in the foregoing table.

East Ohio distributes the gas purchased from Hope in the northern and eastern parts of Ohio—Cleveland, Akron, Canton, Massillon and Youngstown being the principal cities. River distributes in Marietta, Ohio, but the sales to it are insignificant and since the rates to it were not affected by the Commission's orders no further reference to it will be made. Peoples, Fayette and Manufacturers distribute the gas purchased from Hope in various communities in Pennsylvania, of which Pittsburgh, served in

(*Continued from preceding page*)

desired the court to read. R. I, II and III as prepared for this Court contain only this matter printed below. Where an exhibit is referred to in this brief and not followed by a reference to the printed volumes in this Court, it will be found in the certified copy of the transcript. Pages of the oral testimony in the original transcript which have not been printed in R. I, II and III are referred to as "Tr."


HOPE NATURAL GAS CO.
OUTLINE MAP
AS OF DECEMBER 31, 1938
SHOWING ITS
PRINCIPAL PIPE LINES (6" TO 20")
COMPRESSOR STATIONS (47)
PRINCIPAL DISTRIBUTION PLANTS
DELIVERY POINTS TO EXPORT CUSTOMERS
OHIO
PA.
DELIVERIES TO EAST OHIO
DELIVERIES TO PEOPLES
DELIVERIES TO FAYETTE
DELIVERIES TO RIVER GAS
DELIVERIES TO MANUFACTURERS
MARSHALL
MONONGALIA
WETZEL
TYLER
MARION
PLEASANTS
HARRISON
DODDRIDGE
WOOD
RITCHIE
BARBOUR
WIRT
LEWIS
UPSHUR
GILMER
JACKSON
CALHOUN
ROANE
BRAXTON
WEBSTER
CLAY
UTNAM
ON
MARIETTA
ST. MARYS
SCHULTZ
PARKERSBURG
ELLENBORO
CENTERVILLE
SALEM
SMITHBURG
BRIDGEPORT
LIGHTBURN
WESTON
SUTTON
GASSAWAY
CORNWELL
INDIAN CREEK
GALLAGHER
HASTINGS
PADEN CITY
SISTERSVILLE
MAXWELL
HAZEL GREEN
CRAIG
MACFARLAN
COXS MILL
BURNSVILLE
JONES
RUSSET
CABOT
EVANS

(FROM EXHIBITS Nos. 1 and 1A)

part by Peoples, is the largest. All of the purchasing companies have local and other supplies of gas. The domestic and commercial consumers on the Hope-East Ohio-Peoples systems totaled almost 710,000 in 1940. (Ex. 4, R. I, 118-126; Ex. 2B, 4).

Between pages 4 and 5 of this brief appears a map showing Hope's principal pipe lines, compressor stations and delivery points to its export customers, taken from Exs. 1 and 1A appearing at R. III, opposite 33. The thousands of small gathering lines and the extensive gas producing fields are not indicated on this map. An idea of the extent of Hope's properties can be gained from the following statistics for 1938 (Ex. 2, 1, 3A; Ex. 4, R. I, 110-111):

	Total Mileage	3 Inch Equivalent Mileage[4]
Field and Transmission Lines	4,024	9,545
Distribution Lines	892	929
Number of Compressor Stations	47	Stations
Total Compressor Station Horsepower	93,470	Horsepower
Number of Gas Wells Owned	3,302	Wells
Number of Vendors' Gas Wells	12,600	Wells
Number of Gas Purchase Contracts	340	Contracts
Operated Leasehold Acreage Owned	337,790	Acres
Unoperated Leasehold Acreage Owned	647,180	Acres

A full description of Hope's properties, their history and their method of operation as testified to by Mr. Tonkin, Hope's President, is contained in Exhibit 4 and related exhibits, important parts of which are printed at R. I, 103-142.

[4] Mileage of pipe of all sizes expressed in terms of equivalent amount of pipe of 3″ diameter, for instance 1 mile of 6″ pipe being equivalent to 2 miles of 3″ pipe.

2. Hope's Rate History.

Because of constant reiteration by petitioners to the effect that Hope has "recouped" a large part of the cost of its properties from the public (Com. Brief, 3, 18, 71, 74, 78-85; Cleve. Brief, 8, 20, 40, 42, 44, 53) it is necessary to say something about the rate history of Hope and of its largest customer, East Ohio. Both companies were organized in 1898 by the same interests, the one to be primarily a producing company in West Virginia and the other to be a distributing company in Ohio (Ex. 4, R. I, 123). Gas rates in Ohio in 1898, as now, were fixed by ordinances passed by municipal councils. If these ordinances were accepted by the utility they became a contract for the period fixed in the ordinance not exceeding ten years. (Ohio General Code, Sections 3982, 3983). After the passage of the Ohio Public Service Commission Act in 1911 a utility dissatisfied with an ordinance rate had the right to appeal to The Public Utilities Commission from the rates fixed by Council (Ohio General Code, Sections 614-44 *et seq.*).

In 1898 East Ohio procured its first franchise from the City of Akron. The ordinance granting this franchise provided a rate of 25¢ per M.c.f. for the first 5 years and 30¢ for the succeeding 5 years. This ordinance was accepted by East Ohio and fixed the rate up to 1908. *The East Ohio Gas Company v. The City of Akron*, 81 O. S. 33, 90 N. E. 40 (1909).

In 1902 East Ohio accepted a franchise from the City of Cleveland which fixed a rate of 30¢ per M.c.f. for a period of 10 years. In 1911 a new ordinance was passed by Cleveland and accepted by East Ohio continuing the rate of 30¢ per M.c.f. for 8 years and increasing it to 35¢ per M.c.f. for the last two years. This ordinance by its terms expired February 6, 1921. *State ex rel. The City of Cleveland v. Court of Appeals*, 104 O. S. 96, 135 N. E. 377 (1922).

The rate charged by Hope to East Ohio prior to 1910 does not appear from the record or decided cases. Ex-

hibit 5 shows that beginning March 1, 1910 the rate for gas furnished by Hope to East Ohio was fixed at 50% of the amount paid by East Ohio's domestic consumers, provided that this should not be less than 15¢ per M.c.f. prior to May 31, 1918 and not less than 17½¢ for 2 years thereafter. It thus directly reflected the terms of the Cleveland ordinance.

Thus until the early 1920's East Ohio's rates were fixed by contract for periods of ten years in advance and Hope's rates to East Ohio were similarly fixed. Following the large depletion of Hope's fields by World War I and the increased costs of operation that occurred after that period, Hope's rates to East Ohio and East Ohio's rates in Cleveland were substantially increased to approximately present levels as a result of the litigation reported in the case last above cited (Ex. 5, 24).

In 1931 Cleveland passed an ordinance reducing East Ohio's rates which, on appeal, the Ohio Commission sustained. *East Ohio Gas Company v. City of Cleveland*, 4 P. U. R. (N. S.) 433 (1934). Hope agreed to absorb a part of this rate reduction and reduced its net rate to East Ohio to 38.5¢ (Ex. 5, 24). In 1937 a provision for a discount on gas purchased by East Ohio for resale to large industrial consumers in order to enable East Ohio to sell industrial gas in competition with other fuels reduced Hope's average rate to East Ohio to 36.5¢ (Ex. 5, 28).

Since 1937 to the effective date of the Commission's rate reducing order the average rates collected by Hope from its export business were as follows (Ex. 11, 5; Ex. 37, 17, 45):

From	Per M.c.f.
East Ohio	36.5¢
Peoples	35.5¢
River	35.0¢
Fayette	31.5¢
Manufacturers	31.5¢
Average	35.9¢

Differences in the terms and conditions of these various contracts accounting for the differences in prices were fully explained by Mr. Tonkin (Ex. 4, R. I, 112-118).

These export rates have enabled Peoples in Pittsburgh and East Ohio in Cleveland to maintain the lowest domestic natural gas rates in force in any of the 25 largest cities in the United States (Ex. 25, 5; Ex. 50, Table 1).[5]

Nevertheless the Cities of Cleveland and Akron, Ohio, petitioners herein, have attempted to secure still lower rates. In 1932 Akron and in 1937 Cleveland passed rate ordinances prescribing lower rates for East Ohio than those then in force. These being appealed to the Ohio Commission it, among other matters, investigated Hope's interstate rates to East Ohio in great detail and in both cases sustained them as reasonable. Its findings in these respects were substantially sustained by the Ohio Supreme Court in the *Akron* case and completely sustained by that court in the more recent *Cleveland* case. *Akron* case—*Re East Ohio Gas Company,* 17 P. U. R. (N. S.) 433 (1937);

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[5] These exhibits show the following monthly bills, for 16 of the 25 largest cities, resulting from the normal use of natural gas amounting to 37 therms for cooking, water heating and refrigeration. The remainder of the 25 largest cities have manufactured gas at substantially higher rates.

	Monthly Bill	
Pittsburgh, Pa.	$1.93	
Cleveland, Ohio	2.47	
Louisville, Ky.	2.50	
San Francisco, Calif.	2.51	
Los Angeles, Calif.	2.52	
Buffalo, N. Y.	2.67	(Mixed Gas)
Houston, Texas	2.91	
Cincinnati, Ohio	2.92	(Mixed Gas)
Kansas City, Mo.	3.51	
New Orleans, La.	3.72	
Denver, Colo.	4.11	
Detroit, Mich.	4.24	
Washington, D. C.	4.72	(Mixed gas)
St. Louis, Mo.	4.97	(Mixed Gas)
Minneapolis, Minn.	5.07	(Mixed Gas)
Chicago, Ill.	5.46	(Mixed Gas)

The East Ohio Gas Company v. The Public Utilities Commission of Ohio, etc., 133 O. S. 212, 12 N. E. (2d) 765 (1938). *Cleveland* case—*East Ohio Gas Company v. City of Cleveland*, 27 P. U. R. (N. S.) 387 (1939); *The East Ohio Gas Co. v. Public Utilities Commission of Ohio, City of Cleveland v. Public Utilities Commission (2 cases)*; 137 O. S. 225, 28 N. E. (2d) 599 (1940); see Exhibits A and C to Cleveland's "Supplement to Petition and Complaint as Amended" filed in Docket No. G-100 herein on March 10, 1939.

While, therefore, Hope's export rates have never been directly subject to regulation, nevertheless their reasonableness was before the Ohio courts in 1921 and before the Ohio Commission and courts in 1931, 1932, 1937 and now again since 1939. In all of these cases the investigations by these bodies of Hope's properties and operations were as complete as in the case of East Ohio.

The *East Ohio-Cleveland* cases presently pending before the Ohio Commission, frequently referred to in Cleveland's brief (pp. 2, 13, 63) and the Commission's brief (pp. 8, 110-111), arose out of the fact that effective July 1, 1939 Cleveland passed a new ordinance fixing precisely the same rate for natural gas in Cleveland that the Ohio Commission had declared in its order of January 10, 1939 was 13¢ per M.c.f. too low, a holding that was sustained by the Ohio Supreme Court in the last *Cleveland* case above cited.

3. Hope's Financial History.

The repeated statement in the Commission's brief that "the average annual yield on the average annual amount of Hope's capital stock issued for cash or other assets has exceeded 20%" (Com. Brief, 5, 26), is mathematically correct, but wholly misrepresents the true picture. This computation ignores these facts: Hope paid no dividends for the first ten years of its history and put all of its earnings back into the development of its property (Ex. 81, R. III,

13). In that development it was assisted by an associated company that at one time advanced as much as $6,265,000 on open account to enable Hope to make this development (Ex. 81, R. III, 16). Thus the total capital stock issued for the first ten years of Hope's history was only $500,000 although by the end of that time, with advances and earnings put back, it had fixed assets of more than $10,000,000 (Ex. 81, R. III, 16). In 1908 these advances were liquidated when Standard Oil Company purchased $4,500,000 additional stock for cash and at the same time a $5,000,000 stock dividend was declared (Ex. 81, R. III, 13). In any realistic view this stock dividend, representing ten years of earnings on cash capital and cash advances which earnings were reinvested in the business, was issued for cash although the Commission did not so treat it in this computation.

Thus the average annual amount of Hope's capital stock formally issued for cash ($11,328,133 per Ex. 81, R. III, 15, note) is not in any sense a fair base upon which to predicate a percentum of either earnings or yield. In addition, the 20% computation includes in the earnings out of which dividends were paid almost $40,000,000 of net earnings that came from sources other than Hope's natural gas service (Ex. 81, R. III, opp. 17, cols. (c), (k) and (l)).

A more accurate measure of Hope's financial history so far as it has any bearing on rates is, we suggest, its history beginning with 1926.

During the first two decades of its existence Hope had available to it the flush production from the theretofore untapped gas fields of northern West Virginia. It sold enormous quantities of gas at low costs and low prices. A large part of these low cost sales were for industrial, field and other uses of a wholly non-utility character. In the period from 1904 to 1909 its sales ranged from slightly less than 31 million M.c.f. to about 45 million M.c.f. From that time until 1916 its sales were never less than 64 million M.c.f. and in many years larger. In 1916, 1917 and 1918 it

was forced to meet enormous demands upon its system occasioned by World War I, its sales in 1916 being over 102 million M.c.f. (Ex. 2, 2). During this period Hope's earnings steadily increased, reaching $5,221,000 in 1916 (Ex. 81, R. III, opp. 17, col. (j)).

During this period Hope met these demands largely from its own producing fields. As a result of this World War I depletion of its gas reserves Hope was required to extend its system southward after the war even in the face of greatly declining demands. Finally in 1925 it built a long transmission line to southern West Virginia where it could procure additional supplies from producers who had theretofore engaged in the manufacture of carbon black. (Ex. 4, 55-61; Ex. 3A). 1926 was thus the first year of full operation of this extended property and of Hope's greater dependence upon purchased gas.

Since 1925 Hope's sales, revenues and earnings have fluctuated widely each year, depending upon winter weather conditions, industrial activity, the extent of local gas supplies available to its customer companies in Ohio and Pennsylvania, the extent to which it was called upon to meet winter loads from its own gas reserves and other factors (Ex. 4, 61-65).

The following table summarizes its operations:

Year.	Fixed Assets Per Books[6]	Hope's Total Sales Per Books M.c.f.[7]	Hope's Total Sales Per Books Revenue[8]	Depreciation and Depletion Per Books[9]	Hope Net Operating Gas Income Per Books[10]		T Col. (5
(1)	(2)	(3)	(4)	(5)	(6)		(
			(Thousands Omitted)				
1926	$ 47,164	57,156	$ 20,662	$ 2,872	$ 3,479		$ 6
1927	48,762	52,433	19,363	2,809	1,535		4
1928	48,548	55,081	20,635	2,651	2,393		5
1929	52,193	57,444	22,048	2,660	3,234		5
1930	53,009	52,649	19,931	2,677	1,188		3
1931	52,779	47,725	17,993	2,560	699		3
1932	52,412	37,702	14,206	2,329	(805)	Loss	1
1933	52,191	37,080	14,121	1,998	366		2
1934	54,454	43,535	15,986	1,693	1,041		2
1935	54,312	47,133	16,976	1,846	2,279		4
1936	56,106	55,679	20,139	2,013	3,555		5
1937	56,536	58,911	20,366	1,982	2,368		4
1938	56,650	47,921	16,942	1,663	872		2
1939	64,251	51,344	18,119	1,218	2,283		3
1940	65,193	69,056	24,362	1,464	5,337		6
Total	$814,560	770,849	$281,849	$32,435	$29,824		$62
Average	$ 54,304	51,390	$ 18,790	$ 2,162	$ 1,988		$ 4

[6] From Ex. 81, R. III, 16, Col. (b). Fixed Assets for 1939 and 1940 include former Rese Company properties. Other columns include operations of former Reserve Gas Company only.

[7] From Ex. 2, 2 and 2B, 3, R. III, 307.

[8] From Ex. 81, R. III, opp. 17, Col. (b).

[9] From Ex. 81, R. III, opp. 17, Col. (h).

[10] From Ex. 81, R. III, opp. 17, Col. (j).

The figures above include Hope's distribution business, as do all general financial figures used by the Commission. In column (2) is given the fixed assets relating to the natural gas business which average over $54 million. Column (7) represents the net operating gas income before any deduction for depreciation and depletion and averages $4.1 million per annum. In examining Hope's book figures it is necessary to show the combined earnings available for return, depreciation and depletion because of Hope's depreciation policy. That policy was never an attempt to provide for merely the annual depreciation and depletion of the property. Hope's Treasurer, Mr. Chisler, explained that the amounts annually set aside were determined by ascertaining the amount of money needed for current property replacements and the additional amounts which it was

deemed advisable to reserve from earnings to pay for needed improvements (Chisler, R. II, 399-400). As Mr. Chisler said:

> "Well, the whole plan was to keep enough money from revenues, from earnings, to develop the property with." (R. II, 399.)

This policy, of course, explains Hope's large depreciation reserves and its low capitalization. It was a conservative policy that harmed no one and kept available money to make replacements at current price levels and necessary extensions.

Taking these fifteen years Hope's total operating gas income available for return, depreciation and depletion of \$4.1 million on fixed assets which we know from this record were substantially understated on the books at \$54 million cannot be distorted into a showing of excessive or even adequate earnings.

4. Proceedings Before the Commission.

In addition to the parties referred to in the petitioners' briefs, the State of West Virginia and The Public Service Commission of West Virginia were permitted to intervene in the consolidated proceedings before the Commission by order dated April 2, 1940 and the City of Toledo, Ohio, was permitted to intervene in the investigatory proceedings by order dated May 28, 1940. The State of West Virginia subsequently filed a brief opposing the recommendations of the Commission's Staff as being contrary to the interests of West Virginia in tax revenues from utility property and in the securing of reasonable prices for the production and sale for export of an irreplaceable West Virginia natural resource.

The hearings referred to were before a Trial Examiner, and not before the Commission itself.[11]

Hope, being required by the Commission to proceed first with its testimony (R. II, 36), presented all of the evidence which this Court has heretofore held relevant for rate-making purposes and rate base determinations—data as to the dates of the construction of its property and as to changes in price levels, book cost, original cost, reproduction cost and the accrued depreciation in its properties, as well as data on operating expenses for 1937 through 1940 and on rate of return.

The complainants, Cleveland, Akron and the Pennsylvania Public Utility Commission, presented no evidence on rate base or anything else.

The Commission's Staff presented no evidence as to the present value of Hope's properties, but introduced figures showing a rate base consisting of an adjusted book cost of Hope's properties, less a recomputed depreciation

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[11] Hope's application to the Commission for a copy of the Examiner's report in order that it might be apprised of the Government's claims and file exceptions and objections to the report was denied (Order, October 3, 1941). The Commission failed to include the Examiner's report in the certified transcript of the record which it filed with the Circuit Court of Appeals, although inclusion of the report was specifically requested by Hope (Petition for Review, R. IV, 12). In view of the scope of the exhibits and the length of the hearings before the Trial Examiner this case was peculiarly one where the Commission should have followed the practice as to Examiner's reports recommended to insure a fair hearing in *Morgan vs. United States*, 298 U. S. 468, 304 U. S. 1. All other important federal regulatory bodies follow this practice: *Bituminous Coal Division, Department of Interior* (Rule XXIV); *Civil Aeronautics Board* (Rule 5); *Federal Communications Commission* (Commission's proposed findings served on all parties, Rule 1.231 (f) and (g)); *Federal Trade Commission* (Rules XX and XXI); *Food and Drug Administration, Federal Security Agency* (Proposed order issued, Rules of Practice, Sec. 2.712); *Interstate Commerce Commission* (Rules 95 and 96); *National Labor Relations Board* (Rules, Art. II, Secs. 32 and 33); *Public Contracts Division, Department of Labor* (Rules, Part I, Secs. IX and X); *Railroad Retirement Board* (Regulations, Sec. 250.15); *Securities and Exchange Commission* (Rules IX and X).

reserve, plus unoperated leases at book cost, and working capital. It also introduced data as to Hope's operating expenses and statistical data as to rate of return.

A complete list of the exhibits presented by Hope and by the Commission's Staff, classified by subject matter, appears at R. I, 91-101.

Since the true nature and effect of the Commission's determinations can be understood only in the light of the evidence which was before it when it rendered its Opinion and made its rate order, we later summarize this evidence and the Commission's determinations thereon under our discussion of rate base, operating expenses and other factors requiring determination in fixing rates.

SUMMARY OF ARGUMENT.

The judgment of the Circuit Court of Appeals reversing the Commission's orders in this case should be affirmed for the following among other reasons:

I.

RATE BASE.

The Commission began its rate base calculations with a figure more than $17 million below the original cost of Hope's interstate properties here involved. This it did by erroneously considering as "original cost" and "actual legitimate cost" under the Natural Gas Act not the amount of money actually spent by Hope in the construction of those properties, which amount was not in dispute, but only such parts of those amounts as Hope had at the time capitalized on its books under its varying accounting practices of the past. As a result the Commission here fixed a rate base on accounting principles inconsistent with those applied by it in determining annual operating expenses and inconsistent with a proper construction of the term "original cost" as that term is used in the Natural Gas Act and as it is defined in the Commission's Uniform System of

Accounts. Thus it eliminated from the rate base a large part or all of the original cost of some 2600 wells and many other items of physical property now used in rendering public service. There is no justification for this elimination either in theory or in the facts pertaining to Hope's past rate history. It constitutes arbitrary retroactive regulation.

Hope's existing interstate properties were built over a 43-year period commencing in 1898 with half of them built prior to World War I at price levels approximately one-half of those since prevailing. By beginning its rate base calculations with these ancient, partial book costs the Commission disregarded the known, proved and great changes in price levels that have occurred since 1898. Thus its rate base admittedly does not reflect by any amount the change in general price levels since 1898, in the purchasing power of the dollar, or present value by any standard of measurement.

From partial past costs of Hope's properties the Commission deducted a recalculated depreciation reserve which on many substantial items of property left in the rate base less than their present salvage value and otherwise greatly overstated the amount of accrued depreciation existing in fact.

The rate base so fixed is too low under the Natural Gas Act and under the Constitution. Both protect Hope's existing property to the extent of not permitting the Commission to compel its consumption and use at less than a fair return on its present value, and properly so. The Commission's rate base and rate making method here applied further fail to meet the prudent investment or any other standard of reasonableness. They are not supported by reason or experience and are arbitrary and invalid.

II.

OPERATING EXPENSES.

The Commission reduced or eliminated substantial portions of Hope's necessary operating expenses. It failed to allow any annual depreciation upon the properties which it omitted from its rate base and upon properties in service in 1942 which Hope had added to its plant since 1940. On other properties it substantially understated Hope's necessary depreciation expenses by calculating its allowances on past book cost rather than upon the present value of the properties in service. Thus it refused Hope the money necessary to maintain its plant under present price levels. In allocating cost the Commission allowed Hope a wholly inadequate return upon its West Virginia distribution properties. It eliminated Hope's actual expenditures for a deep test well which proved dry. It reduced Hope's expenses by crediting against them substantially all of the earnings from the gasoline and butane business of an affiliated company without adequate allowance to that company for return on its property. Finally, the Commission eliminated millions of dollars of federal income taxes actually paid by Hope in determining past rates and allowed a wholly inadequate amount of federal income taxes in determining future rates.

III.

RATE OF RETURN.

The Commission arbitrarily applied a low present rate of return to its past cost rate base. This combination of ancient cost in the rate base with a present day rate of return is not in accordance with the prudent investment principle of rate making and in any view is unreasonable. The rates of return applicable to the past periods when Hope's properties were being built were shown in the record and the Commission arbitrarily and unreasonably refused to apply them to its past cost rate base.

IV.

VIEWED IN THEIR ENTIRETY THE RATES FIXED BY THE COMMISSION ARE TOO LOW BY ANY STANDARD.

The rates fixed by the Commission are substantially too low on either the present value or the prudent investment method of rate making. They allow Hope less than 4% on any minimum estimate of present value. On the prudent investment basis they allow Hope less than 5% for both return and annual depreciation and depletion. That the rates are too low is shown additionally by the fact that they assume that Hope can continue indefinitely to furnish large quantities of gas to meet present abnormal demands at a delivered cost of 9¢ per M.c.f., whereas the average price which Hope must pay for purchased gas in West Virginia is 18¢ per M.c.f. The Commission's rates cannot be justified on the ground that Hope's financial record in the past has been successful, or on any other ground. Hope's recent experience attempted to be added to the record at this time indicates that even upon the Commission's own rate making theories the reduction which it ordered is excessive.

V.

THE COMMISSION'S FINDINGS AS TO LAWFULNESS OF PAST RATES.

The Commission's retroactive determination of rates for the three and a half year period prior to the effective date of its order fixing rates for the future is beyond its authority. The Natural Gas Act authorizes it to fix only future rates "to be thereafter observed and in force" (15 U. S. C. 717d (a)). It contains no authority to order reparations or to make retroative determinations. These retroactive findings are based upon the same formulas applied in fixing future rates and are therefore invalid. Additionally, they retroactively judge the reasonableness of past rates each year by hindsight instead of by foresight and thus impose an arbitrary and unreasonable standard of conduct.

ARGUMENT.

I. RATE BASE.

(Com. Brief, 33-99; Cleve. Brief, 28-52)

A. SUMMARY OF THE EVIDENCE AND THE COMMISSION'S DETERMINATIONS.

1. Costs New.

Originally both parties introduced evidence as to rate base as of December 31, 1938. Thereafter such evidence was brought down to various later dates. Because all of the original exhibits develop figures as of December 31, 1938 we shall use these figures hereinafter unless the text otherwise indicates.

In submitting evidence of the rate base for the interstate business both parties excluded all distribution property and likewise excluded certain property used to carry coke oven gas used as fuel in Hope's compressor stations. For 1940 by stipulation of the parties the properties, revenues and operations of the former Reserve Gas Company, a subsidiary of Hope whose properties and business Hope acquired by merger on December 30, 1939, were excluded (Stipulation, Ex. 77; Tonkin, Tr. 302). It will be understood that all figures hereafter used referring to rate base exclude all of these items.

The items which entered into the interstate rate base were these:

(1) The physical properties, including production system, transmission system and general property;

(2) Operated leaseholds;

(3) Useful unoperated leaseholds;

(4) Working capital; and

(5) Capital additions after 1940.

Items (4) and (5) were the subject of separate allowance and figures for them will not be included in the present discussion of property costs.

Although items (1), (2) and (3) are separately dealt with in many of the exhibits, we believe it will contribute to simplicity of explanation hereafter to combine them and thus show over-all figures for the interstate physical property and leaseholds. If the Court refers to figures in the exhibits and they seem at first not to be the same as those in the brief this varying treatment of leaseholds will explain the difference.

Book Cost. The properties devoted to interstate service as capitalized on the books of Hope as of December 31, 1938 amounted to $52,730,666 (Ex. 20, R. I, 197). The cost so capitalized reflected, of course, the varying accounting practices of Hope over its previous 40-year history. It included only such costs as had been charged to capital accounts on its books at the time the properties were constructed and which had not been retired from the capital accounts. When Hope prepared a detailed field inventory and cost study of its property as of that date it found certain property shown in its capital accounts which did not appear in the inventory and conversely, other property which appeared in the inventory, but was not shown in its capital accounts. Hope made the proper adjustment both ways when it determined the actual original cost of the existing properties (Ex. 20, R. I, 173-177). All of Hope's work sheets and other data with respect to these studies were made available to the Commission's Staff (Ex. 20, R. I, 189).

Adjusted Book Cost. The Commission's Staff began with this $52,730,666 book cost and prepared an adjusted book cost, making changes to correct what it called "accounting errors." It accepted Hope's inventory. It then made the same adjustments downward which had been made by Hope for the items of property which had been retired from service but not retired on the books as shown

by this inventory, but made only a small part of the upward adjustments which had been made by Hope to include the cost of the items of property not shown on the books but actually found to exist by the inventory. The balance of these necessary upward adjustments were not made by the Staff, either on the theory that the cost of these existing items of property had originally been charged to other than capital accounts or on the claim that no voucher for them as separate items could be found in Hope's records. The adjusted book cost so arrived at by the Staff for Hope's interstate property was $51,792,000 (Ex. 57, R. I, 219-221).

Original Cost. Hope at the direction of the Commission under Section 6(b) of the Natural Gas Act prepared and introduced a statement of the original cost of its property (Ex. 20, R. I, 167). In so doing it considered original cost to mean the amount of money actually spent to construct the various items of property now in service at the time they were constructed regardless of how the expenditures were at the time charged on the books. For reasons hereinafter fully discussed the full original cost was not capitalized on its books. Accordingly Hope went back to its original work orders, vouchers and other records to ascertain what they recorded the actual construction cost of the existing properties to have been at the time of construction and found the actual original cost of all the property now in service to be $69,735,000 (Ex. 20, R. I, 195-197).

The Staff introduced no statement of original cost but claimed that its "adjusted book cost" was also the "original cost" and the "actual legitimate cost" (Smith, R. I, 270).

The difference between the Staff's figures and those of Hope depend on a question of law which is fully discussed beginning at page 30 below.

Increased Price Levels. Hope's properties in service on December 31, 1938 were constructed gradually over a period of more than forty years. Necessarily its costs, both original and book, reflected the varying price levels that prevailed over those years. In order to show the effect of these changing price levels upon Hope's property the costs of the various items of property constructed in each year were adjusted by the application of price trends to show what they would have cost if constructed when and as they were but substituting the prices for labor and materials paid by Hope in 1938 for the prices actually paid at the time of construction. The purpose of this was to show just how much change there was in the level of prices applicable to this property over the 40-year period (Ex. 20, R. I, 195-197).

The result of this trending was to show that had the property been constructed in the manner it was, but at 1938 prices, the amount of money actually paid therefor (original cost) would have been $105,101,000 in place of the actual original cost of $69,735,000 (Ex. 20, R. I, 193). Thus the price level applicable to this property in 1938 was more than 50% higher than the average price level prevailing at the times the various items of property were constructed. Exhibit 20 (R. I, 207) contains a summary of the original cost by years together with the trended original cost as shown in the exhibits.

This summary further shows that one-half of Hope's present property was constructed prior to 1917 at an original cost in round figures of $25,000,000. The other half was constructed since 1917 at an original cost of $45,000,000. Accordingly, if both halves of Hope's present property had been constructed over the years since 1917 its original cost would have been $90,000,000, and if its books had been kept in accordance with the present Commission System of Accounts, the recorded book cost would now be $90,000,000.

Reproduction Cost New. Hope presented an estimate of reproduction cost new of $97,340,000 (Rhodes, Ex. 16-A, R. I, 165, Ex. 16-B to I, inclusive; Ex. 37, 50). This estimate was made by George I. Rhodes of Ford, Bacon & Davis, a widely experienced engineer in the design, construction and operation of many natural gas systems. It was most carefully prepared.[12] It contained no estimate whatever for the cost of developing the business, or for going concern value, or for any discovery value of the great gas fields developed by Hope (Ex. 16-A, R. I, 162). In other words, it included only the estimated cost of reproducing the physical property with leaseholds included at actual cost.

It will be noted that this reproduction cost is nearly $8,000,000 less than the trended original cost. This is to be expected. The trended original cost reflected a construction of the property by the methods and in the exact manner employed at the time the various items were constructed but at prices prevailing in 1938. The reproduction cost contemplated a present reproduction of the property at one time by the most modern and efficient methods.

The record also showed that The Public Utilities Commission of Ohio in passing on the rates of Hope's affiliate, East Ohio, determined a reproduction cost new of Hope's interstate property as of June 30, 1937 in the amount of $100,257,000 (*Cleveland* case, *supra*, pp. 8-9, Exhibits A and C to Cleveland's "Supplement to Petition and Complaint as Amended" herein, Docket No. G-100, Table 6,

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[12] No Commission witness testified that Hope's properties could be built at present price levels at anything less than the aggregate amount shown in Hope's exhibit. Criticism was made only by one Staff witness as to installation costs on field and transmission lines and as to what pipe prices prevailed in 1938 (Bodner, Ex. 73 and 73A, R. III, 83-95). The record showed that pipe on large scale pipe line projects in 1941 cost more than the 1938 pipe prices used in Hope's exhibit (Rhodes, Tr. 5541-5555; Tonkin, Tr. 5760).

p. 117). Pipe prices as of the date of that determination were higher than the 1938 prices which Mr. Rhodes used. As of 1941 and later, the Ohio Commission's finding of reproduction cost new is probably more accurate than that of Mr. Rhodes (Rhodes, R. II, 72; Tr. 5541-5552; Tonkin, Tr. 5760).

Hope further offered evidence to show that the reproduction cost new determination by the Ohio Commission as of 1937 was merely an adjustment to that date of a reproduction cost new of Hope's physical property agreed to as of 1931 and 1932 between the engineers of East Ohio and of the complaining Cities of Cleveland and Akron. This evidence the Commission excluded (Exs. 121 and 122; Tr. 5927-5945).

2. Accrued Depreciation.

Hope's Evidence. On behalf of Hope Mr. Rhodes and his engineering assistants determined the amount of accrued depreciation existing in all of Hope's properties as of December 31, 1938, that is the extent to which their total service life had already expired (Rhodes, R. II, 421-422). This determination was made by methods appropriate to each of the several property classifications (Ex. 21, R. I, 355-367; Ex. 22).

Accrued depreciation in Hope's 3300 gas wells was determined on the basis of the proportionate decline in useful rock pressure from the time the wells were drilled to the date certain (Ex. 21, R. I, 356-358). Depreciation of pipe lines was determined by extensive sampling and inspection of buried pipe in 1939, the measurement of the pitting of the pipe inspected, the application of rules developed by the U. S. Bureau of Standards expressing the behavior of pitting in buried pipe and a final determination of the overall extent to which the service life of the pipe lines had been consumed to the date certain (Ex. 21, R. I, 358-360;

Rhodes, R. II, 440-442). Depreciation accumulated in compressor station equipment was based on a 1939 field observation of this equipment, a study of the history of its use and operation, retirements and other factors affecting its service life (Ex. 21, R. I, 360-361). Depreciation accumulated in property in other accounts was similarly determined from inspections in 1939 and similar investigations. In all accounts where necessary an additional allowance was made to provide for accumulated depreciation or expired service life that could not be determined from inspection (Ex. 22).

Mr. Rhodes found Hope's physical properties as a whole to have an average accrued depreciation of 34.51% and a corresponding present per cent condition of 65.49%. The present per cent conditions of the principal classes of physical property were found to be as follows (Ex. 21, R. I, 369-371; Ex. 38):

	Physical Properties	Reproduction Cost New	Percent Accrued Depreciation	Resulting Percent Condition	Cost New Less Depreciation
332-1	Gas Well Construction	$19,321,139	68.7 %	31.3 %	$ 6,047,517
332-2	Gas Well Equipment	10,874,199	43.6	56.4	6,133,048
333-1	Field Lines	17,282,312	26.	74.	12,788,911
352-2	Compressor Station Structures	1,957,473	28.	72.	1,409,381
353	Transmission Mains	16,500,288	21.	79.	13,035,228
354-2	Compressor Station Equipment	9,874,271	19.	81.	7,998,160
	All other accounts	4,868,675	20.4	79.6	3,874,030
	Undistributed Construction Costs	14,296,099	23.66	76.34	10,913,139
	Total	$94,973,856	34.51%	65.49%	$62,199,414

Before this Hope evidence was presented counsel for the Commission assumed that Hope would claim merely "observed physical deterioration" of its properties, as utilities often have (see, for example, *Natural Gas Pipeline* case, 315 U. S. 586, Note 4). However, when questioned on this point Mr. Rhodes explained clearly that he had de-

termined the accrued depreciation from all causes (R. II, 424).[13]

The Commission's Staff's Evidence. The Commission's Staff did not undertake to determine by inspection of Hope's properties, by a study of their use and operation, by a study of the past depreciation experience of Hope, or otherwise, what the present actual existing depreciation was in any or all of Hope's properties or what proportion of their service life had expired. Instead Mr. French, a Staff engineer, estimated total service lives for each kind of Hope property—for example 45 years for field line pipe, 40 years for gas well tubing and casing, 39 years for compressor station equipment and 64 years for transmission line pipe (Ex. 65, R. III, 172-173). There was a great deal of evidence showing that these estimates on Hope's long-

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[13] "Q. [By Commission Counsel] Then really, your condition per cent was based upon observed physical deterioration in the Hope properties, was it?

"A. [Rhodes] We started with observed physical deterioration. *There was added to that* all of the effects of obsolescence and things of similar nature which have been and are leading to the retirement of Hope's property, *and on top of all that, there was added* an allowance which I deemed sufficient to cover all depreciation of all other kinds, existing in the property." (R. II, 424)

Mr. Smith of the Commission's Staff in his general oral testimony on depreciation principles (Smith, R. I, 380, 383-384) commented unfavorably on what he called "the observed depreciation" method. However, on cross examination he readily admitted that these comments had nothing to do with Hope's testimony in this case (R. I, 388):

"Q. In your comments upon observed depreciation, do I understand that you were not referring to Mr. Rhodes' testimony?

"A. I was speaking generally of observed depreciation studies.

"Q. And you weren't referring specifically to the testimony in this case?

"A. That is correct."

lived properties were either based on erroneous calculations or were mere "judgments" or guesses by Mr. French (Ex. 65, R. III, 151; Exs. 84, 85, 86, 87, 101, 102, 103, 104; French, Tr. 3463, 3465, 3478, 3484, 3490-3493, 3502, 3508, 3523, 3532-3534, 3553, 3578, 3601; Rhodes, Tr. 5239-5395).

Next Mr. French converted his estimated service lives into annual depreciation rates by dividing the lives into 100—for example the 45 years for field line pipe became 2.22%, the 40 years for gas well tubing and casing became 2.5% and so on (R. III, 172-173). The Staff accountants then applied these annual depreciation rates to their "adjusted book cost" of the properties to compute a so-called "reserve requirement" (Dunn, Ex. 61, R. III, 175). In other words, they calculated the depreciation reserve that they claimed Hope would have accumulated if it had started in 1898 and had each year applied Mr. French's rate to Hope's book costs for its plant (Dunn, R. II, 540-541). Similar computations, using estimated percentages of annual gas withdrawals, were used to arrive at a revised depletion "reserve requirement" for some properties which the Staff claimed should be "depleted" rather than depreciated (Ex. 61, R. III, 180-181, 187). In this instance also there was much evidence showing that the estimated percentages of withdrawal were erroneous and were erroneously applied and that some of the properties which the Staff depleted were not in fact subject to depletion (Exs. 88, 93-97, 100, 119, 141; Dunn, R. II, 473-510; Tollefson, Tr. 4919-4994; Rhodes, Tr. 5233-5237, 5966-5976; Tonkin, Tr. 5773-5785).

As a result of all its computations the Staff worked out an "Adjusted Depreciation Reserve" of $23,501,355.80 as of December 31, 1938 (Ex. 61, R. III, 184-186).

3. The Commission's Rate Base Determinations.

The Commission's rate base calculation was as follows (Opinion, R. I, 50):

	December 31, 1938	December 31, 1940
"Gross Investment in Gas Plant in Service" (including all leaseholds[14])	$51,792,000	$52,523,000
Less: "Actual Existing Depletion and Depreciation"	21,188,000	22,328,000
"Net Investment"	$30,604,000	$30,195,000
Add: "Working Capital"[15]	2,100,000	2,125,000
"Interstate Rate Base"	$32,704,000	$32,320,000

For the purpose of its order reducing future rates the Commission used the rate base shown for December 31, 1940 plus an allowance of $1,392,000 (Opinion, R. I, 50) for one-half of Hope's net capital additions during the years 1941 to 1943. The corresponding figures for December 31, 1938 are shown because in the evidence heretofore stated it was figures of that year that were used.

[14] The unoperated leaseholds were found by the Commission, as the evidence showed, to be "useful or imminently useful and * * * necessary for the continued and efficient production of natural gas" (Finding (14), R. I, 4). The Commission's further finding that "its cost should be included in the rate base" (*ibid.*) was clearly required by the evidence. This was no item of "liberality" for which any credit may be claimed, as the petitioners now try to do (Com. Brief, 31).

[15] In addition to an uncontested amount for materials and supplies the Commission allowed $871,407 cash working capital as of December 31, 1938 and $896,401 for 1940 (R. I, 49). Hope's testimony showed that as a practical business matter it needed at least $1,750,000 (Ex. 36, Chisler, Tr. 1781-1782). The Commission brief's reference to "Hope's corrected claim" (p. 32) is apparently based on the lower court's remark that if certain adjustments were made in Hope's estimate the result would be less than the Commission's allowance (R. IV, 194). This remark overlooked the offsetting adjustment to include prepaid items which the Commission recognized in its Opinion had to be made (R. I, 49). This allowance by the Commission of half the cash working capital Hope testified it needed is another of the items of "liberality" for which it now claims credit (Com. Brief, 32).

As we have seen, when the Commission fixed the above rate base it had before it the following undepreciated costs or values for the interstate property as of December 31, 1938:

Book Cost	$ 52,730,000
Staff's Adjusted Book Cost	51,792,000
Original Cost	69,735,000
Original Cost at 1917-1938 prices	90,000,000
Original Cost Trended to 1938 prices	105,101,000
Reproduction Cost New:	
Ohio Commission—6/30/37	100,257,000
Company—12/31/38	97,340,000

The Commission started its rate base computation with the exact dollars shown by its Staff's adjusted book cost of $51,792,000.

The source of the "Actual Existing Depletion and Depreciation" in the Commission's rate base calculation is the Staff's "Adjusted Depreciation Reserve" of $23,501,-355 as of December 31, 1938. The Commission revised this reserve downward to $21,188,000, on the basis of four of the obvious errors pointed out by Hope in the application of the Staff's own theories (Kennedy, Exs. 137 and 138, Tr. 6492-6519; Opinion, R. I, 43-45). However, following the Staff's general notions, the Commission said this "required depreciation and depletion reserve" is "the best evidence of the measure of actual existing depreciation and depletion and it will be deducted from the actual legitimate cost of the Company's property for rate making" (Opinion, R. I, 45).

This "required depreciation and depletion reserve" is about 41% of the adjusted book cost from which it was deducted to arrive at the Commission's rate base.

The Commission's "Net Investment" rate base includes operated and unoperated leaseholds at cost less depletion in the amount of $1,212,600 for December 31, 1938 (R. I, 50; R. III, 188). Thus its "Net Investment" rate

base for Hope's physical properties is $29,391,400 for December 31, 1938.

The present value of these physical properties was determined at $66,166,382 as of June 30, 1937 by The Public Utilities Commission of Ohio in the *Cleveland* case, *supra*, pages 8-9, and affirmed by the Supreme Court of Ohio in that case (R. IV, 171; Exhibits A and C to Cleveland's "Supplement to Petition and Complaint as Amended," Docket No. G-100, Table 6, p. 117).

These physical properties which appear in the Commission's rate base at about $29,000,000 were valued for 1941 taxation by the State of West Virginia at over $50,000,000 (Ex. 108, R. I, 391-393; Tr. 5431-5433, all excluded by the Commission[16]).

B. THE RATE BASE CALCULATION OF THE COMMISSION STARTED WITH A FIGURE THAT IS OVER $17,000,000 BELOW THE ACTUAL ORIGINAL COST OF HOPE'S INTERSTATE PHYSICAL PROPERTIES AND LEASEHOLDS.

(Com. Brief, 70-89; Cleve. Brief, 39-46)

1. Statement of This Issue.

We start with this issue, not because it is the most important, but because whatever method of arriving at a rate base is adopted, an important element of evidence is the true original cost.

At the direction of the Commission (R. II, 36), pursuant to Section 6(b) of the Natural Gas Act, Hope prepared a detailed field inventory and a statement of the original cost of its properties (Ex. 20, R. I, 167-207) *supra*, pages 20 to 21. In doing this Hope followed the accounting principles set forth in the Commission's Uni-

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[16] This exclusion was erroneous. *City of Lima v. The Public Utilities Commission*, 106 O. S. 379, 140 N. E. 147 (1922); *Greencastle Water Works Co. v. Public Service Commission of Indiana*, 31 F. (2d) 600 (D. C., S. D. Ind., 1929); *Great Falls Gas Co. v. Public Service Commission of Montana*, 34 F. (2d) 297 (D. C., D. Mont., 1929).

form System of Accounts (Ex. 58, R. III, 41-68) and the new West Virginia System of Accounts which is practically identical with the Commission's System (Ex. 13). The statement of original cost prepared by Hope is the statement which its books would actually show today had they been kept from the beginning in accordance with the new System of Accounts (Antonelli, R. II, 226, 179, 207). All annual operating statements prepared by the various parties in this case were prepared in accordance with the same System. Thus Hope achieved an entire consistency between the accounting principles used in preparing the annual operating statements and the accounting principles used in determining all evidence as to rate base. Proceeding in this way it found that the amount of money actually spent to construct Hope's present properties as of December 31, 1938 was $69,735,000 (Ex. 20, R. I, 195-197).

As we have seen, in preparing the original cost statement ordered by the Commission Hope went back to its original work orders and vouchers and determined the actual amount of money spent for each item of existing property at the time of its construction (Ex. 20, R. I, 174, 195-197). The original work orders and vouchers were available for this to the extent of 94% of the property. In the case of the remaining 6% estimates were made of the probable cost at the time of construction[17] (Antonelli, R. II, 184).

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[17] In determining the original cost of the properties by examination of its books of account, vouchers and other records and similar records of its predecessor companies, Hope was unable to secure records relating to minor amounts of property acquired from other utilities, the original cost of which had to be estimated upon the basis of Hope's experience in constructing similar properties under similar circumstances and during like periods (Ex. 20, R. I, 182). Similar estimates had to be made in the case of a few small field lines laid prior to 1907, a few early compressor station and other structures, and minor miscellaneous equipment (Ex. 20, R. I, 186, 188-189). In certain other cases the actual total cost of a group of properties was allocated among several properties on the basis of estimates but the total amounts included in original cost were determined directly from actual records and vouchers (Ex. 20, R. I, 186-187).

As we have noted, the Commission's Staff started with Hope's book costs of $52,730,666 and adjusted them for what it found to be "accounting errors" to $51,792,000, with which the Commission began its rate base calculation (Opinion, R. I, 50). This latter figure the Commission and its Staff referred to variously as "Investment in Gas Plant per Books as Adjusted" (Ex. 57, R. I, 219), "Gross Investment in Gas Plant in Service" (Opinion, R. I, 50), "Original Cost" (Ex. 57, R. I, 209, 215) and "actual legitimate cost" (Order, R. I, 10, 11).

The Commission made no attempt whatever to determine original cost on the accounting principles set forth in its Uniform System of Accounts and thus to make its rate base accounting consistent with its annual operating statement accounting.

Thus the difference between the parties is fundamentally a question of what is original cost. There was no dispute about the facts. It was conceded by Staff witnesses that if the Staff's conception of original cost had been the same as that of Hope the Staff would have arrived at substantially the same dollars shown by Hope (Smith, R. I, 300; Pace, R. I, 318-321, 324-326). Thus whether the Commission or Hope correctly stated what money was actually spent to construct Hope's existing properties is not in issue. Admittedly Hope's original cost figures show this.[18]

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[18] In the reply brief filed by the Commission's Staff before the Commission the correctness of this statement was admitted in the following language, page 12:

> "On page 40 of the Company's Brief the statement is made that Mr. Smith and Mr. Pace of the Commission's Staff would not differ with the Company's claims on gross dollars that were originally spent on the various Company accounts. This is a correct statement, but does not disclose the complete picture. The other half of the picture is the past voluntary assignments by the Hope Company to operations of a part of the gross dollars originally expended. * * *"

The difference between the parties consisted of the following items (Ex. 59, R. I, 351, 353):

Drilling and other direct well construction costs for 2,633 wells	$12,643,641
Other direct material and labor costs of buildings, pipe lines and other miscellaneous property	1,380,154
Field and general overheads, including interest during construction	3,825,126
Total	$17,848,921

Brief comment as to each of these is necessary.

Prior to 1923 Hope had charged the cost of drilling wells to operating expenses (Ex. 20, R. I, 185). The first West Virginia System of Accounts became effective as to Hope in 1923 (Ex. 117; Chisler, R. II, 174) and required these costs to be capitalized as does the Commission's present System of Accounts (Ex. 58, R. III, 41). Hope now has in service approximately 3300 wells the total direct drilling cost of which was a little more than $16,500,000 (Ex. 20, R. I, 195-197). Of this $16,500,000 a little over $4,000,000 is capitalized on the Company's books and represents the 772 wells now in service which were drilled or drilled deeper after 1922. The Commission in its so-called "original cost" has in the inventory the 3300 wells. In the equipment account it has the cost of equipping 3300 wells but in construction or well drilling cost it has only the cost of drilling or drilling deeper 772 wells (Pace, R. I, 318-320). Hope, of course, has included the cost of drilling all wells now rendering public service (Opinion, R. I, 25). This one item accounts for $12,643,000 of the difference between the original cost as determined by Hope and by the Commission.

$1,380,000 of the difference represents all or a large part of the cost of the following among other items of property now actually being used by Hope to produce and deliver gas, which the Commission excluded entirely from its original cost (Ex. 59, R. I, 349-353; Ex. 60):

275 warehouses, barns, garages, blacksmith shops, sheds, tool houses, storage buildings and wash houses;

686 pits, bridges, fences, pipe skids, pipe racks and sidewalks;

2,945 benches, racks, heaters, cabinets, tables, truck flat beds and accessory items;

152 miles of pipeline trench for lines from 1" to 20";

9,584 telephone poles with crossarms, brackets, pins and insulators;

122 meter houses;

1,386 meter boxes;

752 installation costs for tanks, pumps, motors, engines, gas coolers, boilers, traveling cranes, etc.

When a check of Hope's inventory with its books disclosed property such as this in the inventory was not on the books, and some property on the books was not in the inventory, Hope made the adjustments both ways in all cases (Ex. 20, R. I, 177) but the Commission did not.

Let us illustrate by a concrete example. On one of its main transmission lines, H-3, Hope put in a new river crossing which cost over $10,000. At the same time the old river crossing was taken out and retired from service. On its books, however, Hope charged the cost of the new river crossing to expense and left the old river crossing, which cost $8,000, in its capital account. When the preparation of the inventory and the examination of the records disclosed this Hope deducted the $8,000 cost of the old river crossing from, and added the $10,000 cost of the new crossing to, its original cost statement (Antonelli, Tr. 5025-5026).

When the Commission accountants checked this they adopted the reduction of the book costs to retire the old river crossing but declined to include in their adjusted book costs the cost of the new river crossing, presumably because that had been previously charged to expenses. The result is that in the Commission's rate base there is not one penny on account of this river crossing now in use. There were many items of property so treated by the Staff. (Antonelli, Tr. 5026-5027).

$3,825,000 of the difference represents overhead costs of constructing Hope's properties (Ex. 59, R. I, 349-353) which at various times in the past Hope charged to operating expenses or, in the case of interest during construction, did not enter on its books at all since Hope did not account for the interest which its own funds were entitled to earn. In the case of these items as in the case of others there was no substantial disagreement as to the amount of these costs but the Commission and its Staff disallowed them on the ground that they had not previously been capitalized (Smith, R. I, 251-254).[19]

We turn then to the meaning of original cost.

2. Meaning of Original Cost.

The differing conceptions of original cost of the Commission and Hope may be tersely stated. Mr. Smith, the Commission's chief accountant, defined original cost as

> "the cost accounted for in the past [on the Company's book plant accounts] exclusive of errors in accounting." (Smith, R. 1, 233-234).

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[19] Both Hope and the Commission's Staff excluded from current operating expenses all current overhead costs on current property construction. Hope did so to be consistent between rate base and operating expenses. The Staff was not consistent in that it also excluded overhead charges from capital accounts. The Commission in its Opinion (R. I, 49-50) added current overhead costs to current operating expenses, thus in this instance eliminating the inconsistency in the Staff's accounting treatment. Hope made no claim in any of its exhibits for current overhead charges in operating expenses and none of Hope's figures shown in this brief indicating the results of current operation include them. Hope of course is not entitled both to the capitalization of overheads and an annual allowance in expense for overheads.

Hope's decision to treat overheads as current expense, referred to in the Commission's Opinion (R. I, 49), was made in view of the anticipated action of the Commission excluding overheads both from rate base and from operating expense. In testing rates the capitalization method gives Hope the proper allowance. The current expense method used by the Commission and based solely on the overheads incurred in the improvements and betterments made in a single year does not.

This means that if, in accordance with any acceptable practice prevailing at the time the entries in the books were made, expenditures were charged to operating expense they cannot now be considered a part of the original cost, even though by the present System of Accounts they are required to be charged to capital account and even though no corresponding items now appear in expense (Smith, R. I, 238). Thus to Mr. Smith and the Commission "original cost" and "actual legitimate cost" mean no more than the recorded book costs slightly adjusted for what are determined to be "accounting errors" made at the time (Smith, R. I, 233-234; 287-288).

Hope's conception of original cost is that it means the amount actually paid to establish the utility to be ascertained as a fact from the Company's books, work orders, vouchers and other direct evidence, if possible, and to be estimated where these are not available, and that this must be done in accordance with the same accounting principles that are used in setting up the annual operating statements. Otherwise, as will be shown later, the cost of gas is either understated or overstated. Without such consistency rates cannot be fair.

(a) Meaning of original cost prior to the passage of the Natural Gas Act.

The term "original cost" inserted in the Natural Gas Act by Congress in 1938 was not a new conception. It was at least as old as the fair value rule itself and was stated in *Smyth v. Ames*, 169 U. S. 466, as one of the facts to be considered as evidence of value.

What courts, commissions, economists and accountants have all recognized as a proper definition of original cost is nowhere better stated than by Mr. Justice Brandeis, in his celebrated concurring opinion in *State of Missouri, ex rel. Southwestern Bell Telephone Company vs. Public Service Commission*, 262 U. S. 276. In a note at page 295

he defined original cost and the method of determining it as follows:

"Original cost is the amount actually paid to establish the utility. The amount is ascertained, where possible, by inspection of books and vouchers, and by other direct evidence. If this class of evidence is not complete, it may be necessary to supplement it by evidence as to what was probably paid for some items, by showing prices prevailing for work and materials at the time the same were supplied. But the evidence of these prices is merely circumstantial, or corroborative, evidence of the amount actually paid. In determining actual cost, whatever the evidence, there is no attempt to determine whether the expenditure was wise or foolish, or whether it was useful or wasteful. Historical cost, on the other hand, is the amount which normally should have been paid for all the property which is usefully devoted to the public service. It is, in effect, what is termed the prudent investment. In enterprises efficiently launched and developed, historical cost and original cost would practically coincide both in items included and in amounts paid; that is, the subjects of expenditure would coincide, and the cost at prices prevailing at the time of installation would substantially coincide with the actual cost."

Nothing could be plainer than that in Mr. Justice Brandeis' view, original cost is the amount of money originally paid to establish the utility. He said nothing about the amount of money that was charged to capital accounts on the books of the company and nothing about corrections for accounting errors. He said original cost was a *fact* to be ascertained by an examination of the original work orders, vouchers, books and other records of the company. If the cost of part of the property could not be ascertained from direct evidence, it was to be estimated and evidence received "as to what was probably paid for some items."

Not only was this Mr. Justice Brandeis' conception but it was the conception of every other writer and authority on

the subject. In Appendix B at page 159 below we have printed excerpts from numerous economists, accountants, courts and commissions all of which in varied language say that original cost is the amount of money spent in the construction of the present property, that it may or may not be represented by the book cost, and that it is to be determined as a fact from all the evidence including estimates where these are necessary to supplement records.

(b) The provisions of the Natural Gas Act support Hope's construction.

Not only did Congress thus use words with a well settled meaning but the language of the Natural Gas Act itself indicates this construction. Section 6(b) of the Act requires a natural-gas company upon request of the Commission to file an inventory of its properties "and a statement of the original cost thereof." If by original cost it meant merely the company's book cost there was no occasion for an inventory and the Act should have provided that the company should file a statement of its balance sheet accounts or a statement of the capital accounts on its books. Since these are a part of every financial statement that a gas company makes there was really no reason for inserting Section 6(b) at all if the Commission's interpretation is correct. Clearly the statement of original cost required by Section 6(b) was a statement of the cost of the various items of its property shown in the inventory and not simply the ordinary statement of a company's plant accounts.

Where a natural-gas company is required to file an inventory of all its property under Section 6(b) it is an anomalous construction of that section to hold that in stating the original cost of that same property it shall state only the cost of so much of the property as was at the time of construction capitalized on its books. Specifically, here Hope was required to file an inventory including all of its 3300 wells. It is not to be supposed that it is then to state

as the original cost of drilling these 3300 wells the cost of drilling or drilling deeper only 772 of them, which is all that is recorded in Hope's plant accounts or included in the Commission's "original cost" (Ex. 16, Pt. B, 95; Pace, R. I, 319).

Plainly Section 6 of the Natural Gas Act contemplates the amount of dollars "actually paid to establish the utility" as Mr. Justice Brandeis said and not merely "the cost accounted for in the past exclusive of accounting errors" as Mr. Smith said (R. I, 233-234).

(c) Hope's construction of "original cost" was adopted in 1939 by the Commission in its uniform system of accounts.

As authorized by Section 8 of the Natural Gas Act the Commission on November 3, 1939 adopted a Uniform System of Accounts to become effective as to all natural-gas companies on January 1, 1940. This is Exhibit 58 (R. III, 41). Its purpose and its language both support the construction of the term "original cost" adopted by Hope and deny that used by the Commission in its decision in this case.

To bring uniformity, consistency and comparability to the balance sheet and income accounts of natural-gas companies the Commission's Uniform System of Accounts required, first, that after January 1, 1940 all balance sheet and income accounts should be kept in accordance with its requirements, with gas plant properties shown in capital accounts at their original cost and, second, that the properties existing on January 1, 1940 should be reclassified into the new plant accounts in accordance with the requirements of the new System (Ex. 58, 16, 36-37, R. III, 47-49). The original cost which was thus to be shown not only for the properties built in the future but for all existing properties was defined to mean the amount of money actually paid for the property by the person first devoting it to

public service.[20] No previous system of accounts for gas companies had required such a restatement of the cost of the property installed prior to its effective date.

Thus all natural-gas companies were required to make a new start by restating their plant accounts on their books at original cost as of January 1, 1940 precisely as though the new Uniform System of Accounts had been in effect from the beginning. This original cost was defined as Mr. Justice Brandeis had defined it and of course had to be determined in the same way for all companies in order to

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[20] The Commission's Uniform System of Accounts requires that Account 100.1, Gas Plant in Service, shall "include the original cost of gas plant" (Ex. 58, p. 16). Original cost as applied to gas plant is defined to mean "the cost of such property to the person first devoting it to public service" (Ex. 58, R. III, 44). Cost is defined as meaning "the amount of money actually paid for property or services or the cash value at the time of the transaction of any consideration other than money" (Ex. 58, R. III, 42). Thus the original cost to be shown for property in service is the amount of money actually paid for it by the person first devoting it to public service. See Gas Plant Accounts 100.1, 100.2, 100.4, 100.5 and 107 and the instructions relating thereto (Ex. 58, 16, 17 and 36; R. III, 47). Cost is to be "ascertained by an analysis of the utility's records" (Ex. 58, Instruction 2B, R. III, 48) and original cost is to be "estimated if not known" where properties have been acquired (Ex. 58, Instruction 2C, R. III, 48).

The footnote at page 74 of the Commission's brief stating that the present System of Accounts prohibits the reaccounting for items properly charged to expense in the past is based upon the existence of one sentence in the "Instructions" (Ex. 58, R. III, 48). Instruction 2 B says among other things that in making a classification of accounts to show original cost it is "not intended" that adjustments be made to record amounts previously charged to operating expenses "in accordance with the uniform system of accounts in effect at the time or in accordance with the discretion of management as exercised under such uniform system of accounts." This one sentence is inconsistent with every other definition, direction and instruction in the code (Antonelli, R. II, 179-180). Moreover, Hope's charges to expense in prior years, such as well drilling costs, were not so charged "in accordance with the uniform system of accounts in effect at the time." These charges occurred mostly prior to 1923 (Ex. 99, 10; Chisler, R. II, 174) when there was no uniform system of accounts applicable to Hope (R. II, 174).

achieve the object of uniformity. The result of this requirement was that all natural-gas companies would show their plant accounts both for old and new properties on the same basis in accordance with the new System and consistent with their operating expense statements. All companies would be on a uniform and comparable basis.

All this the Commission denied by its Opinion in this case. Instead it interpreted this accounting code to require the continued statement of the cost of items of plant acquired prior to 1940 in accordance with past accounting practices of each individual company, so long as they do not involve what are called "accounting errors." Mr. Smith answered "absolutely" to a question as to whether he would "freeze the accounting practices of the Company, if they were not due to error, in their statement of plant accounts" (Smith, R. I, 287-288).

To be more specific, if two companies had each spent $10,000 in drilling and $10,000 in equipping a well in 1920 and one company had charged the drilling cost to capital account and the other had charged it to expense, both being acceptable methods of doing it at the time, the Commission would now have one company continue in its plant accounts as the original cost of its well $20,000 and the other company $10,000. And if a third company had charged both the cost of drilling and equipping a well to expenses at the time it was drilled and this were at the time a recognized accounting practice the Commission would have that well included in the statement of original cost at zero (Smith, R. I, 288-289, 293). And this would be true although all of these wells are today in active operation and supplying gas to consumers. The Commission would include in the respective rate bases of these companies $20,000 in one, $10,000 in another and $0 in the third, less in each case, except the last, a computed depreciation reserve.

3. The Commission's Determination of a Rate Base Inconsistent with Its Determination of Operating Expenses Has Arbitrarily Understated Hope's Cost of Gas.

All operating expense statements submitted by the parties and as found by the Commission conform to the accounting requirements set forth in the Commission's Uniform System of Accounts which became effective January 1, 1940. Hope adjusted its operating statements for the years prior to 1940 in order to conform them. As previously pointed out, Hope likewise followed these accounting requirements in determining original cost. The Staff admitted that Hope's rate base and operating statements were consistent (Smith, R. I, 298, 300).

The Commission has not been consistent. It has taken Hope's book costs that reflect the accounting practices of 40 years, slightly adjusted them for what it determined to be accounting errors and thus has a rate base that clearly is not constructed on the same accounting principles as the operating statements.

The Commission's reason for its inconsistency is thus stated in its Opinion (R. I, 29):

> "No greater injustice to consumers could be done than to allow items as operating expenses and at a later date include them in the rate base, thereby placing multiple charges upon the consumers."

In Note 12, page 18 of the Opinion (R. I, 32) the Commission further says:

> "Costs of exploration for and development of future gas reserves are considered current operating costs by the industry and Hope has included such costs in its current operating expenses. If retroactive accounting were allowed then the Company might restate these costs as capital investment in the future productive acreage. The Commission will allow $600,000 in annual operating expenses for exploration and development costs in fixing rates. If this item were permitted to be restated in plant cost ten years from now

$6,000,000 would be added to the rate base resulting in multiple charges to consumers."

The reasons thus set forth by the Commission are repeated in its brief in this Court (pp. 86-87).

Let us take this illustration selected by the Commission and see what the effect upon rates will be if it is treated as the Commission suggests it should be or with consistency as Hope claims.

Case One on Commission's Theory. Hope is to have $600,000 per year in expenses for exploration and development costs, which represents roughly 1¢ per M.c.f. in the cost of gas. Suppose effective January 1, 1944 the Commission's System of Accounts is changed to require that thereafter all exploration and development costs shall be capitalized and suppose that it becomes necessary to fix a new rate for Hope as of January 1, 1945. Since these costs have not previous to 1944 been capitalized and since, on the Commission's theory, now to do so and include them in the rate base would result in multiple charges to consumers, there will appear in capital account on Hope's books on January 1, 1945 only $600,000 by way of exploration and development costs—the amount capitalized in the year 1944. This and only this would go into the rate base. And since for the year 1944 the System of Accounts would no longer allow development costs to be charged to operating expenses, there would be nothing in operating expenses for this item. In computing the rate, therefore, the Commission would have in the rate base only $600,000 and if it allowed Hope say 10% of this amount for return and depletion there would be in expenses only the annual capital charges of $60,000 per year, or 1/10th of 1¢ per M.c.f. in the cost of gas. In other words, Hope's cost of gas has apparently been reduced approximately 9/10ths of 1¢ per M.c.f. solely because the change the Commission ordered in accounting has been applied fully to income statement but only partially to capital account.

Case Two on Commission's Theory. Let us now see how the rule works in reverse. Suppose exploration and development costs prior to 1944 had been charged to capital account and effective January 1, 1944 were thereafter required to be charged to operating expenses. In fixing a rate as of January 1, 1945 the Commission would find in capital account about $20,000,000 (Ex. 26, 9) representing exploration and development costs capitalized prior to 1944. This would go in the rate base at a depleted condition of the wells of approximately 30% or about $6,000,000 (Ex. 26, 9) upon which, again assuming 10% for return and depletion, Hope would be allowed $600,000 as capital charges in its rates. But in operating expenses of the test year 1944, in accordance with the changed System of Accounts, it already would have $600,000 representing the exploration and development cost of that year. If consistency between operating statement and rate base is disregarded, and adherence to accounts as entered is insisted on, as the Commission claims, the result of this change in accounting requirements would be an allowance to Hope of $1,200,000 per year for exploration and development costs, or the equivalent of about 2c per M.c.f. in the cost of gas. This is about twice the normal cost that has been assumed and is again due solely to a change in accounting ordered by the Commission and not fully applied both to rate base and operating statements.

In other words, the Commission's method, which fails to preserve any consistency between rate base and operating expense statements, inevitably results either in an understatement or an overstatement of the cost of gas whenever there is a change in accounting practice.

Effect of Consistency. On the other hand, if consistency is maintained there will be no substantial change in the cost of gas. There will be approximately $600,000 allowed in operating expenses either directly as current annual exploration and development costs or through capital

charges on past costs. Thus the cost of gas will not fluctuate with each change in accounting practice ordered by the Commission.[21]

Consistency requires that when *any* cost is included in current expense all *like* costs must be eliminated from the rate base, and in reverse when *any* cost is excluded from current expense and capitalized all *like* costs *must* be included in the rate base. Duplicate charges can occur only when the expenditures are considered in determining both current expense and rate base.

One more illustration of the effect of the Commission's inconsistency is important in this case. Well drilling costs were not capitalized prior to 1923 but since that date under the various codes of account they have been. Suppose that down to January 1, 1937 the cost of drilling presently operated wells had been capitalized in the amount of $16,500,000, and then beginning January 1, 1937 by a change in the System of Accounts such costs were required to be

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[21] It is difficult to believe the Commission was familiar with the record in this case when it selected this particular illustration of exploration and development costs. In Exhibit 26 Mr. Rhodes worked out the two methods of handling exploration and development costs. The one method he called "Industry Practice of Charging to Expense" and the other method the "Capitalization Method" (Ex. 26, 11). In the first method he used the average of Hope's exploration and development costs for the years 1937 to 1939, both inclusive, as fairly representative; in the second method he capitalized all Hope's exploration and development costs from the beginning down to December 31, 1938, attributed these to all operated acres Hope had ever developed, and retired these costs in proportion as operated acres were retired, depleting the remainder on the same basis as the wells. At all times he maintained complete consistency between rate base and operating expense statements.

He found that on the basis of an 8% rate of return the expense method would put $669,702 annually in operating expenses, whereas the capitalization method would put in expenses $742,390 (Ex. 26, 11). On the basis of a 6½% return, which the Commission used in this case, the figures become $652,240 on the expense method and $655,187 on the capitalization method. The difference between the two methods is wholly inconsequential.

charged to operating expenses. On the Commission's theory the $16,500,000 less depletion would go into the rate base and Hope would be given a return and annual depletion allowance thereon. At the same time there would go into operating expenses the annual well drilling costs for the years 1937 to 1940, resulting in a substantial duplication of cost at the expense of consumers.

It is a partial reverse of that situation that is presented here. Well drilling costs were not capitalized prior to 1923. Since that time they have been. The book costs therefore reflect only the cost of drilling 772 wells drilled since 1922 but do not show the cost of drilling 2600 wells now in use but drilled prior to that time. On the other hand, in operating expenses of the test years 1937 to 1940 there is no allowance for well drilling costs. The result is that the Commission's order includes an inadequate and sub-normal allowance for well drilling. *It has no allowance for return or depletion on the drilling cost of 2600 wells from which gas is currently being supplied to consumers.*

The Commission's inconsistent basis for operating expenses and rate base is arbitrary and demonstrates that its interpretation of "original cost" in the Natural Gas Act is unsound.

4. The Omission from the Commission's Rate Base of any Consideration of Property Costing Over $17,000,000 is not Justified on the Ground that These Costs have been Recouped by Hope from Consumers or on Other Grounds.

(Com. Brief, 78-85; Cleve. Brief, 39-46)

The justification for the omission of these property costs is placed on various grounds. It is said that a company should not be permitted to impeach the integrity of its books or discretions exercised by management (Opinion, R. I, 31). The principal claim, however, is that Hope's rates were larger in the past than they would have been

if these expenditures had been charged to capital account and that in consequence Hope has "recouped" the expenditures from consumers and no longer has any investment in them (Opinion, R. I, 34; Com. Brief, 78-85; Cleve. Brief, 42).

As to impeaching books it is clear that Hope in setting forth a correct original cost in accordance with modern accounting procedures is not in any wise impeaching its books or its records. In fact it uses all of those for the purpose of finding the true cost. This no more impeaches these records than would a determination of reproduction cost new or any other method of measuring the value of the whole property as presently existing.

Moreover, it is to be observed that the position is not one for which Hope is responsible. Hope might well have been charging well drilling costs to operating expenses up to the present day had not West Virginia in 1923 ordered it to do otherwise. That as a matter of proper accounting West Virginia was right in requiring well drilling to be capitalized the Commission admits by its own System of Accounts. Thus the Commission, not Hope, has reversed former decisions of management on accounting matters. *But the Commission seeks to reverse these decisions only as to the operating statement and not as to the capital statement, thereby substantially understating the present cost of gas.*

As to whether Hope's rates in the past were higher then they otherwise would have been, the Commission's assumption is contrary to both theory and fact. In theory, costs will be somewhat higher by the capitalization method than by the expense method used by Hope in the past. This is obviously so because in the capitalization method interest or return on the amount capitalized must be included whereas in the expense method this is not so. In theory, therefore, Hope's rates in the early days (if they were determined in accordance with modern regulatory theories) were lower because they were determined on an

expense method as to the items in dispute than they would have been if they had been determined by the capitalization method.

Laying theory aside, the fact is that Hope's bookkeeping methods prior to 1923 had little to do with fixing rates. As previously shown in the Statement, *supra*, pages 6 to 9, Hope's largest customer, East Ohio, made its earliest contracts with Akron and Cleveland in 1898 and 1902 for ten-year periods in advance and in the case of Cleveland, East Ohio's largest customer, renewed it for a ten-year period in advance to expire in 1921. Hope also fixed its contract rates to East Ohio for ten-year periods in advance.

Thus until 1921, which covered practically all the period when well drilling and other costs were being charged to expenses, the rates to Hope's principal customer and the rates to East Ohio's principal customers were all fixed by long term contracts in advance. In fact the first ones were made for ten years in advance of any exact knowledge of what operating expenses would be. After these contracts were made it was a matter of no consequence to any one what items either East Ohio or Hope charged to operating expense. Consumers who were able because of these contracts to replace artificial gas containing 550 B.t.u. and costing certainly not less than 75c per M.c.f. with natural gas containing 1100 B.t.u. at 30c per M.c.f. were not concerned either with how much money the two companies made or how they kept their books.

These simple facts are a complete answer to all the assumptions and theories in the petitioners' briefs that consumers in the past paid items charged to expense on the books or paid higher rates than they otherwise would when as a matter of fact the rates were fixed long before the book entries were made.

The truth is that this "recoupment" theory is merely a thinly disguised attempt at retroactive regulation covering the past 44 years without going through the steps neces-

sary to proper regulation. Obviously what effect a different method of treating well drilling costs in any year prior to 1923 would have had on rates could only be determined by a careful determination of rate base and operating expenses for that year and similarly for other years. It cannot be determined merely on the assumption that a utility that made money from the natural gas business and from other sources has made enough over its entire history so that its well drilling costs have been "recouped." Such an assumption would be equally applicable to capitalized costs of any property.

Nor is it helpful to refer to the case of *Re Hope Natural Gas Co.*, P. U. R. 1921E, 418 (1921) (Opinion, R. I, 29). It is true that in that case, which concerned only rates in West Virginia, Hope, in accordance with its then accounting practice, included current well drilling costs in operating expenses and consistently did not capitalize past well drilling costs. Also, in repeated recent cases in Ohio Hope's well drilling costs have all been capitalized and the current well drilling costs excluded from expense (Smith, R. I, 283-284). Consistency was preserved in every case. There was no duplication of costs and no omission.

However, it is interesting to note that in this West Virginia case the West Virginia Commission found that for the years 1918, 1919 and the first six months of 1920 Hope failed to earn the return from its utility business fixed by the Commission by $1,100,000 per year (*ibid.* 433). Here is a direct finding that at least in that thirty-month period prior to 1923 Hope was not recouping its drilling costs in addition to a fair return from its utility operations.

General statements as to Hope's earnings during this or any other period (Opinion, R. I, 34) are not a substitute for such necessary determinations because, as we have seen at page 10, *supra*, over its history Hope has had approximately $40,000,000 of earnings from other sources than its natural gas service. Also, a great portion of Hope's early natural gas sales were not to "rate payers" at all, but

were field sales to drillers, pumpers and others in West Virginia (Tonkin, Ex. 2, 2; Ex. 4, 50-51).

Had the Commission attempted to determine any "recoupment" as a matter of fact, that attempt would have forcibly illustrated that the rate making theories the Commission applied in fixing Hope's rate base in this case are wholly retroactive. Without making this necessary "recoupment" determination the Commission nevertheless eliminated these early well drilling and similar property costs from the rate base. Such retroactive rate regulation is not authorized under the Natural Gas Act and is obviously arbitrary under the Constitution.

This is not to say that there may not be particular cases where the principles of estoppel are applicable as to utilities' past accounting practices, as for example in *Los Angeles Gas & Electric Corp. v. Railroad Commission*, 58 F. (2d) 256. This and the other cases cited by the petitioners on this point are analyzed in Appendix C, page 174, *infra*. They lend no support to the Commission's retroactive determinations in this case. We have also set forth in Appendix B, page 159, *infra*, a number of court and commission decisions establishing that in the absence of particular estoppel it is wholly improper to eliminate property items from the rate base because they were in the past charged to operating expenses.

Additionally in *Board of Public Utility Commissioners v. New York Telephone Company*, 271 U. S. 23, at page 32, this Court said:

> "Customers pay for service, not for the property used to render it. Their payments are not contributions to depreciation or other operating expenses, or to capital of the company. By paying bills for service they do not acquire any interest, legal or equitable, in the property used for their convenience or in the funds of the company. Property paid for out of moneys received for service belongs to the company, just as does that purchased out of proceeds of its bonds and stock."

The application of this decision to the Commission's determination in this case is direct. When Hope included well drilling costs in operating expenses the effect was equivalent to the setting up of a 100% depletion or depreciation reserve on each well as drilled in each year, rather than accruing a depletion reserve on the basis of the production from that well spread out over a number of years. The Commission's decision here is in substance that Hope's future rates should include less return and a lower depletion charge than otherwise necessary because, in the Commission's view, Hope has charged excessive depletion amounts on these wells in the past. Hence Hope should furnish free to present consumers the annual use and annual consumption of its pre-1923 wells and other property. This is just what this Court condemned in the *New York Telephone* case.

The Commission itself recognized this principle in its treatment of Hope's depreciation reserve in this case. Commissioner Scott, dissenting from the Commission's Opinion (R. I, 80-89), advocated the deduction from the rate base of Hope's entire book depreciation reserve on the theory that it was built up of annual charges to expense and hence was "contributed by the customers," saying that he could "see no distinction between property which has been constructed by the company through charges upon the consumers by operating expenses labelled, for example, 'well drilling expense' and property which has been constructed by the company through charges upon the consumers by operating expenses labelled 'depreciation and depletion expense'." (Dissenting Opinion, R. I, 83). The Commission, however, recognized that where, as here, a "large part of the Company's business is brought under regulation for the first time" it is improper to deduct the book reserve (Opinion, R. I, 40).

In his concurring opinion Commissioner Manly pointed out the immateriality of past charges in a case such as this (R. I, 77-78):

"Attention should also be directed to the fact that, until the passage of the Federal Power Act in 1935 and the Natural Gas Act in 1938, the depreciation policies of both the electric utilities and the natural gas companies, as regards their interstate operations, were not subject to regulation. Under such conditions, while it is true that the amounts set up on the books as depreciation reserves were derived from revenues collected from customers, they did not, as under regulation, play a determining part in fixing the level of rates and the consequent amount of the revenues. Without regulation, the good old rule of 'What the traffic will bear' is controlling and depreciation policies are an afterthought, determined by the management and board of directors. It follows therefore that, during the pre-regulatory period, the customers would not have contributed any more or less to the company's revenues, regardless of what depreciation program was pursued."

What Commissioner Manly said as to Hope's prior depreciation practices is equally and exactly applicable to Hope's practice as to these well drilling and other costs. What charges it made on its books in the past were wholly immaterial to its customers or to others, and the effect retroactively given them by the Commission is wholly arbitrary.

It should be apparent from the foregoing discussion that the Circuit Court of Appeals was wholly correct in determining that the Commission should not have excluded these wells and similar property from the rate base whether that be fair value or original cost (R. IV, 184-189).

C. THE RATE BASE ON WHICH THE COMMISSION'S ORDER RESTS DISREGARDS PRESENT VALUE AND IS CONTRARY TO THE NATURAL GAS ACT AND TO CONSTITUTIONAL REQUIREMENTS.

(Com. Brief, 34-70; Cleve. Brief, 28-38, 56-59)

1. The Commission Ignored the Present Value of Hope's Properties.

As we have seen, *supra*, pages 27 to 30, the Commission started its rate base calculation with the Staff's adjusted book cost of $51,792,000. It thus gave no consideration whatever to the estimates of reproduction cost new presented by the Company or as found by the Ohio Commission, or to the trended original cost. It took no judicial notice of the known increases in price levels during the last forty-five years. In other words it disregarded all evidence of present value and even evidence of the true original cost. Nowhere does it claim that its rate base reflects present value.

The judges below were unanimous in pointing out that the Commission made no attempt to ascertain and paid no attention to the present value of Hope's properties (R. IV, 172, 203).[22]

Before discussing the invalidity of such a rate base under the Natural Gas Act and the Constitution we point out that the Commission's failure to determine whether its rates permitted a fair return on present value cannot be justified on the ground that Hope's evidence was not entitled to any probative value and hence there was no other evidence than book cost. This is not a case in which

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[22] The Commission's brief argues (pp. 43-44) that "There is no evidence that present value is greater than original cost." Quite so. The $69,735,000 original cost of Hope's properties is in excess of their present value, but the Commission's rate base does not use this original cost, or even that part of it included in its adjusted book cost, but deducts a revised depreciation reserve to arrive at a $31,000,000 result which no one can claim or has claimed is anything less than a fraction of the present value of Hope's properties determined on any reasonable basis.

the provision of Section 4(e) of the Natural Gas Act is applicable. It says (15 U. S. C. § 717 c (e)):

> "At any hearing involving a rate or charge *sought to be increased*, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company."

Here Hope sought no increased rate. On the contrary, complaints were filed against Hope's existing rates on the ground that they were unreasonable and in response thereto the Commission began its investigation. It follows that the burden of justifying these charges and supporting any reduced rates was upon the complainants or the Commission, and that the latter could make no order unless sustained by evidence of present value, if it be, as Hope submits, that both the Natural Gas Act and the Constitution require that rates permit a fair return upon present value. In such circumstances and in view of the fact that much of Hope's existing property was built before World War I it was the duty of the Commission or the complainants to introduce evidence of present value of the kind they believed convincing and the duty of the Commission to consider it.

Plainly, as the Circuit Court of Appeals said, it was also the duty of the Commission to take judicial notice of the greatly changed general price level, if present value is to be determined (R. IV, 180-181).

Moreover, the findings that original cost, trended original cost and reproduction cost as presented by Hope are all without "probative value" (see R. I, Findings (7), (8), (9) and (10)) obviously mean no more than that the Commission rejected and disregarded all evidence as to rate base other than the Staff's adjusted book cost. In note 6, page 9, of its Opinion (R. I, 23) the Commission says that under the *Natural Gas Pipeline* decision—

> "such estimates of reproduction cost and trended 'original cost' need not have been admitted in evidence."

We turn then to the question of the validity under the Natural Gas Act and the Constitution of a rate base which is less than present value.

2. The Natural Gas Act Requires a Rate Base Not Lower Than Present Value.

(Com. Brief, 36-39; Cleve. Brief, 28-34)

Under the Natural Gas Act Congress intended the rate base to be no lower than present value. This most clearly appears in Section 6, which provides as follows (15 U. S. C. Sec. 717e):

> "Ascertainment of Cost of Property"
>
> "Sec. 6 (a) The Commission may investigate and ascertain the actual legitimate cost of the property of every natural-gas company, the depreciation therein, and, *when found necessary for rate-making purposes, other facts which bear on the determination of* such cost or depreciation and *the fair value of such property.*
>
> "(b) Every natural-gas company upon request shall file with the Commission an inventory of all or any part of its property and a statement of the original cost thereof, and shall keep the Commission informed regarding the cost of all additions, betterments, extensions, and new construction."

It will be observed both from the title and the provisions of this section that it is not limited to rate-making. Both the statement of "original cost" and the determination of "actual legitimate cost" which are referred to in Section 6 may be useful to the Commission for accounting, depreciation and other purposes as well as rate making.

Section 6(a) also authorizes the Commission to investigate and ascertain "when found necessary for rate-making purposes, other facts which bear on the determination of * * * the fair value of such property." Thus when rates are to be fixed the Commission is not only to investigate and ascertain "actual legitimate cost" but

other facts which bear on the determination of the "fair value" of such property. The Commission is thus to determine fair value having before it actual legitimate cost and other facts evidencing fair or present value.

Of these sections the Circuit Court of Appeals said (R. IV, 175):

> "It was clearly the intention of Congress that under these sections the Commission might investigate and ascertain cost and depreciation of properties of natural gas companies, irrespective of whether a rate inquiry was involved or not, and that, where rate making was involved, the investigation might extend to other facts which bear on cost or depreciation and the fair value of the property. Instead of prescribing a change in the method of determining the rate base, it is clear that the statute contemplates that the base should be determined in accordance with existing legal rules; and it is basic in these rules that the present fair value of the property be ascertained so that rates may be established which will afford a fair return upon fair value and so will not be confiscatory in the constitutional sense. This we understand to be the construction given the Act in the recent case of *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U. S. 575, 585, 586, * * *."

The legislative history of the Natural Gas Act supports the construction placed upon it by the Court of Appeals. Appendix A beginning at page 141 of this brief shows the complete legislative history which we shall briefly summarize:

The Public Utility Act of 1935 as originally introduced (Senate Bill 1725 and House Bill 5423, 74th Congress, 1st Session) included a provision as to rate base applicable both to Title II of the Act which was the Federal Power Act and to Title III which regulated natural gas companies. Section 211, subparagraph (a), gave the Commission power to ascertain "the actual, legitimate, prudent cost of the property of every public utility" and subparagraph (c) provided that the Commission "shall fix such rate as will

allow a fair return upon the actual legitimate prudent cost of the property used and useful for the service in question." As originally introduced it was designed to make prudent investment the rate base.

The Senate Committee on Interstate and Foreign Commerce reported out a revised version of the Public Utility Act of 1935 (S. 2796) omitting Title III, relating to natural gas companies. The section referred to above was renumbered Section 208 and, as introduced and passed by the Senate, still referred only to the "actual legitimate cost of the property." The House Committee on Interstate and Foreign Commerce substantially amended the Senate Bill (S. 2796) and changed what had now become Section 208 of the Federal Power Act to read precisely as Section 6(a) of the Natural Gas Act now reads except that it referred only to electric companies and not to natural-gas companies.

The Chairman of the House Committee in explaining the change in the Senate Bill said (see Appendix A, p. 149 below):

> "After the recent decision of the Supreme Court in a Maryland telephone case it is practically a futile thing, in my judgment, for any legislative body to try to write a rate-making base. * * * we have provided that rates shall be reasonable and just, and under the Supreme Court decision that means that the valuation must be based upon the current value of the property.
>
> "Cost is an element of the rate base, but only an element. The cost of reproduction might be an element, but only an element. The one question is the current value of the property, and the Supreme Court will permit no deviation from this principle." (Congressional Record, Vol. 79, Part 9, p. 10378, 74th Cong., 1st Sess.)

The Maryland telephone case referred to above was *West v. The Chesapeake & Potomac Telephone Co.*, 295 U. S. 662. In that case the Maryland Commission attempted to arrive at a rate base by adjusting historical cost by

means of general commodity price indices. The District Court reversed its order and itself arrived at a rate base by taking the book cost to the time of its determination, deducting the book depreciation reserve and adding an allowance for working capital. This Court held that neither the Commission nor the District Court had arrived at a figure reflecting present value and affirmed the lower court's holding that the order made was confiscatory and invalid.

Certainly the majority opinion adhered to the fair value rule and the minority opinion approving the Maryland Commission's rate base was predicated on the view that the Commission was being condemned for the method it used (trended prices) and not for the confiscatory result. After criticizing replacement value Mr. Justice Stone said, 295 U. S., 692:

> "Present fair value at best is but an estimate. Historical cost appropriately adjusted by reasonable recognition of price trends appears to be quite as common sense a method of arrival at a present theoretical value as any other."

This case was decided immediately prior to the passage of the Federal Power Act. It was a case which the members of the Committees had studied and to which the Chairman of the House Committee expressly referred in the quotation previously given. Not only that but Congressman Cole, a member of the House Committee, in the debate on the bill said (Appendix A, pp. 150-151 below):

> "The bill was originally drawn on the theory that for the purpose of just and reasonable rates the Commission should determine the actual and prudent cost of the property less accrued depreciation thereon. Mr. Justice Roberts, in delivering the opinion of the Court in the Telephone case, *supra*, made it very clear that such a provision would be unconstitutional and it was therefore stricken out. In lieu thereof there is new language and while that may not be entirely clear, it was inconceivable to those of us serving on the sub-

committee that any State or National commission establishing valuation of a public utility for rate purposes should do other than follow the very clear formula or standard now established by the Court. No one consideration alone as to value such as legitimate cost or prudent cost, is sufficient; but all elements must be taken into account, such as reproduction value, actual cost, going value, proper depreciation allowance, so that in the end, after considering the aforegoing and such other elements of value as are essential, leave a figure upon which the rate established thereon will not be confiscatory."

The petitioners apparently consider significant the initial failure of the Senate to adopt Senator Bailey's amendment requiring the use of "fair value" as the rate base (Com. Brief, 38; Cleve. Brief, 30). Clearly this means nothing, since the Bill as passed by the Senate four days later, on June 11, 1935, expressly provided for an actual legitimate cost rate base. Subsequently, in August, 1935, this was changed when the Senate concurred in the House amendment adopting the language in the present act.

To complete this history it only need be added that when the Natural Gas Act was later passed in 1938 Section 6 was taken directly from Section 208 of the Federal Power Act. The only change made was in substituting "natural-gas companies" for "public utilities" which latter meant electric power companies.

Thus it is plain that Congress by Section 6(a) of the Natural Gas Act did not authorize the Commission to fix a rate on the basis of depreciated book cost or depreciated actual legitimate cost, unless those under the circumstances reasonably reflected the present value of the property.

3. This Court Has Long Construed the Constitution As Requiring Utility Rates, However Fixed, To Allow at Least a Fair Return on Present Value and That Construction Should Not Be Reversed.

(Com. Brief, 40-70; Cleve. Brief, 56-59)

This Court itself has so often considered this matter, and Judge Parker for the Circuit Court of Appeals has so cogently and forcefully stated the legal basis and the reasons for the continuance of the present value rule (R. IV, 172-184) that we do no more than call the Court's attention to the precise issue that is presented and the principal reasons urged by the petitioners for changing the present value rule.

The Circuit Court of Appeals' decision on this point rests on the precise ground that the Commission "could not absolutely ignore the fact of increased price levels" in determining Hope's rates (R. IV, 181). It did not require the Commission to use reproduction cost or trended original cost or any price trends or any other specific formula. The discussion in the Commission's brief (pp. 42-49) under the heading "The Court Below Erred In Requiring That Price Trends Be Utilized in Determining The Rate Base" is beside the point. The Commission was left free to determine present value by any reasonable method it chose, including "investment cost" if this were "a true measure of the present value of the property notwithstanding increases in prices" (R. IV, 180).

(a) The Legal Basis of the Present Value Rule Is Sound.

The legal basis of the present value rule rests on three simple propositions:

(1) The property is held in private ownership; (2) the Constitution protects the property, not its cost, against confiscation, and (3) on the analogy of eminent domain there is a taking of property when the owner who is re-

quired to use it up for the public is denied a fair return and depreciation thereon. Those principles have been announced in many cases, most clearly in *The Minnesota Rate Cases*, 230 U. S. 352, remained the legal basis of the rule at the time of adoption of the Natural Gas Act (see *West v. Chesapeake & Potomac Telephone Company*, 295 U. S. 662, 671), and certainly have never been rejected in any subsequent decision.

The petitioners do not deny propositions (1) and (2) but they claim that the analogy of eminent domain is inapplicable to rate regulation which should rest solely on the broader principle underlying other price fixing. It is said that the regulation of rates is not a "taking" but is a mere restriction of the owner's use and enjoyment of his property similar to many other regulations, while "eminent domain is the power to command a sale" (Com. Brief, 60).

Nothing could better describe the regulatory power of the government over utilities such as Hope than the "power to command a sale." While this is not the sole difference, in ordinary price and other regulation of businesses which are not utilities the owner of the business is free to continue the operation of the business, or not, as he sees fit, and is free to sell his commodity, or not, as he sees fit. Not so the utility. It is required by law to continue its business unless the government permits it to stop.[23] It is required

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[23] Natural Gas Act, Section 7(b) (15 U. S. C. Section 717f (b)):

"(b) *No natural-gas company shall abandon all or any portion of its facilities* subject to the jurisdiction of the Commission, *or any service rendered* by means of such facilities, without the permission and approval of the Commission first had and obtained, after due hearing, and a finding by the Commission that the available supply of natural gas is depleted to the extent that the continuance of service is unwarranted, or that the present or future public convenience or necessity permit such abandonment."

(*Continued on next page*)

by law to continue to make sales of its product or service to customers who apply.[24] In this case Hope is certainly commanded to sell its gas. Thereby there is in each year taken for the public use all its property consumed in that service and the use of the remainder, for which just compensation must be paid.

After reviewing the legal basis of the present value rule Judge Parker in this case said (R. IV, 177-178):

> "Property has no value except present value. Past value exists only in memory or in history, future value only in estimate or expectation. It is the property presently existing which belongs to the utility and is used by the public. It is that property which is depreciated through use and which is gradually being sold through depreciation to the public. And it is the value of that property as used which must be consid-

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(*Continued from preceding page*)

Note the mistaken statements denying government compulsion on Hope to continue its service appearing in the Commission brief's footnote 25 (p. 62). The non-eminent domain cases there cited deal with the duty of a father to support his child, the liability of a person who voluntarily undertakes to do something for another, and the liability of a contracting party to a third party beneficiary. They have nothing to do with the legal compulsion on a utility to continue service.

[24] Natural Gas Act, Section 7(a) (15 U. S. C. Section 717f (a)):

> "(a) Whenever the Commission, after notice and opportunity for hearing, finds such action necessary or desirable in the public interest, *it may by order direct a natural-gas company to extend or improve its transportation facilities*, to establish physical connection of its transportation facilities with the facilities of, *and sell natural gas to*, any person or municipality engaged or legally authorized to engage in the local distribution of natural or artificial gas to the public, and for such purpose to extend its transportation facilities to communities immediately adjacent to such facilities or to territory served by such natural-gas company, if the Commission finds that no undue burden will be placed upon such natural-gas company thereby: *Provided*, That the Commission shall have no authority to compel the enlargement of transportation facilities for such purposes, or to compel such natural-gas company to establish physical connection or sell natural gas when to do so would impair its ability to render adequate service to its customers."

ered in fixing rates that will reimburse the company for its partial sale through use and provide an adequate return upon investment. * * * It must not be forgotten that it is the property owned by the utility, and not the cash invested by stockholders in its stock, that is devoted to public use; that this property is worn out in furnishing the service which the public receives and which the utility is bound to render; and that, unless the utility receives a rate sufficient to make necessary replacements at current prices with a fair return upon the present fair value of its investment, its property is being taken from it and given to its customers."

The legal basis of the present value rule including the requirement of just compensation on analogy to the taking of property under the power of eminent domain is sound.

The difficulties in the administration of the present value rule are not due to any unsoundness in this legal basis but are due entirely to another matter. For reasons familiar to all the dollars to be used in a rate base to represent present value can not be determined in the ordinary way. A reasonable substitute is necessary. If it be conceded that the usual formula that has been applied which includes reproduction cost has not always worked well as a measure of present value, that practical difficulty does not justify utter disregard of present value. There is not always an easy road to protection of fundamental civil rights, either of liberty or of property. Certainly it does not justify the usual line of reasoning evidenced throughout the Commission's brief and its Supplement, namely that since reproduction cost has not worked well therefore "prudent investment" should be adopted. An infirmity in a particular method of arriving at the dollars to represent the present value of the property does not change the fundamental legal basis that it is still privately owned and that the Constitution does not permit it to be taken either by way of eminent domain or by compulsory sale through compulsory service without just compensation.

In this connection it may be observed that the method of fixing a rate employed by the Commission in this case is based on a practical denial that the property is privately owned. The theory appears to be that consumers gradually acquire ownership of a utility through depreciation or other charges in the rate and that when these charges equal the cost of the property, no matter how low that cost may have been, the utility is not thereafter entitled either to return or depreciation on that property. Thus it says (Com. Brief, 83):

> "There is no principle which would entitle it [Hope] to a continuing return on an item of property whose cost has been fully recovered from the rates received, and which thus does not represent an investment, even though the property involved remains in use."

That is to say when a company, through depreciation charges or other operating expenses has "recouped" its original cost, from that time forward it is required to continue to operate the properties but is no longer entitled to any return. This is but another way of saying that the property is now owned by consumers and not by the utility.

Nothing this Court said in the *Natural Gas Pipeline* case in any way supports this novel view of the petitioners or denies the common sense legal basis of the present value rule. In fact the rates before this Court in that case had been fixed upon a reproduction cost new rate base.

Nor is there anything to the contrary in *Nebbia v. New York*, 291 U. S. 502 (Com. Brief, 63), which was decided one year earlier than *West v. Chesapeake & Potomac Telephone Company, supra*, page 57. The opinion of the Court in each case was written by Mr. Justice Roberts and neither his opinion in the latter case nor that of the minority found any necessity for even referring to the *Nebbia* case. The controlling principles in the two cases are obviously different. In the *Nebbia* case no maximum price was fixed, but merely a minimum price, and so far as the governmental

regulation was concerned, anyone was free at will to charge more than this minimum price or not to sell at all. This distinction was clearly pointed out in the related case of *Hegeman Farms Corp. v. Baldwin*, 293 U. S. 163, where Mr. Justice Cardozo said:

> "* * * For an understanding of the complainant's position both in its economic and in its legal aspects, the fact is of critical importance that there has been no attempt by the Board to fix a maximum price in respect of any of the transactions subject to its regulatory power. What is fixed is a minimum only. None the less, the competition among dealers is so keen that in practice the legal minimum is the maximum that the appellant is able to charge. * * *" (p. 169)
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> "* * * The Fourteenth Amendment does not protect a business against the hazards of competition. *Public Service Comm'n v. Great Northern Utilities Co., supra*, at p. 135. It is from hazards of that order, and not from restraints of law capriciously imposed, that the appellant seeks relief. The refuge from its ills is not in constitutional immunities.
>
> Much is made of a supposed analogy between the plight in which the appellant finds itself and that of public utilities subjected to maximum rates that do not yield a fair return. But the analogy, when scrutinized, is seen to be unreal. A public utility in such circumstances has no outlet of escape. If it is running its business with reasonable economy, it must break the law or bleed to death. But that is not the alternative offered where the law prescribes a minimum. An outlet is then available to the regulated business, an outlet that presumably will be utilized whenever use becomes expedient. If the price is not raised, the reason must be that efficient operators find that they can get along without a change. * * *" (pp. 170-171)

None of the other cases cited by the petitioners support their view that utility rates are constitutionally "reasonable" and not "arbitrary" when they produce less than a fair return on present value. These cases deal with oleomargarine, smoke control, obstructions upon navigable

waters, fish conservation, fire prevention, rationing and the like[25] (Com. Brief, 60-63; Cleve. Brief, 56-59). We know of no case where *maximum* prices have been fixed and it has not been held that upon judicial test inquiry should be made whether just compensation is allowed, except perhaps in war emergency anti-inflationary price regulation where no requirement is made that the vendor continue to sell. Cf. *Wilson v. Brown,* 11 Pike and Fischer OPA Service 612:17 (Emergency Court of Appeals, July 15, 1943).

(b) Considerations Urged by The Commission to Justify the Application of its Particular Rate Making Theories Regardless of Whether its Rates Allow a Fair Return on Present Value Are Unsound.

The Commission insists that it be permitted to use depreciated original cost even where it can not on any reasonable basis find that the resulting rate base is at least equivalent to present value or that its resulting rate is sufficient to allow at least a fair return on present value. In the case of utilities constructed in whole or in large part at the higher level of prices prevailing since World War I present value and depreciated original cost will frequently coincide for all substantial purposes. The Commission, however, insists upon the right to say that even when this is not true depreciated past costs shall control. To cite an extreme case, it insists that if Manhattan Island

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[25] Oleomargarine—*Powell v. Pennsylvania,* 127 U. S. 678; Smoke Control—*Northwestern Laundry v. Des Moines,* 239 U. S. 486; Obstruction upon Navigable Waters—*Monongahela Bridge Co. v. United States,* 216 U. S. 177, *Union Bridge Co. v. United States,* 204 U. S. 364, *West Chicago Street Railroad Co. v. Chicago,* 201 U. S. 506; Fish Conservation—*Lawton v. Steele,* 152 U. S. 133; Fire Prevention—*Standard Oil Co v. Maryville,* 279 U. S. 582; Rationing—*Henderson v. Bryan,* 46 F. Supp. 682; *Morrisdale Coal Co. v. United States,* 259 U. S. 188; Zoning—*Euclid v. Ambler Co.,* 272 U. S. 365; Tree Conservation—*Miller v. Schoene,* 276 U. S. 272; Intoxicating Liquor—*Mugler v. Kansas,* 123 U. S. 623; Bricks—*Hadacheck v. Los Angeles,* 239 U. S. 394; Livery Stable—*Reinman v. Little Rock,* 237 U. S. 171; Right of Support—*Pennsylvania Coal Co. v. Mahon,* 260 U. S. 393.

had been acquired from the Indians by a utility and continuously thereafter devoted to public service, it could now go into the rate base at $24.

In support of this view it urges a number of considerations (Com. Brief, 64-70; Com. Brief's Supplement, 66-89) under the proposition that "We submit that an acceptable and reasonable formula is the prudent investment standard adopted by the Commission" (Com. Brief, 64).

It is important to note that the "prudent investment standard" and the "prudent investment basis of rate regulation," as these terms are used by the various writers cited in the Commission's brief and in its Supplement, are not descriptive of the rate base and method of fixing rates which the Commission in fact employed in the present case. This fact is perfectly illustrated by the Commission's repeated references to experience in Massachusetts and California as demonstrating that its own mislabelled rate making theories are "sound and workable" and have been adopted by "many experienced regulatory bodies" (Com. Brief, 65). To this experience we first turn.

(1) **Experience.** While the phrase "prudent investment" originated in Massachusetts[26] the fact is that Massachusetts has never applied what various writers now call the prudent investment method of regulating rates, and it has certainly never applied the theories which the Commission applied in the present case.

Professor Irston Barnes in his book "*Public Utility Control in Massachusetts*," from which citations are made below, analyzed the claims as to the success of the Massachusetts system. He found:

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[26] The term "prudent investment" originated in Massachusetts because the Commission of that state fixed rates on the amount of money stockholders had "honestly and prudently invested" in a utility although this was more than the then value of its property. In other words, the phrase was coined to justify including in rate base sums in excess of present value, and not vice versa. Wells, *Proceedings of the N. A. R. U. C.*, 1927, pp. 113-114.

(a) In practice the Massachusetts Commission has rarely determined either the prudent investment or any other rate base and nowhere explains how to do it (*Ibid.*, pp. 105, 106, 118, 143, 145, 147, 149).

(b) The small amount of litigation involving the Massachusetts Commission decisions is due to the extremely liberal treatment usually accorded utilities in that state. Of this Professor Barnes says:

> "The normal conclusion must be that the utilities have in the past received more liberal treatment from the Massachusetts Commissions than they could have expected from an appeal to the Federal Courts" (*Ibid.*, p. 206; also pp. 138, 139.)

(c) The outstanding characteristic of Massachusetts regulation is its method of determining fair return. The Massachusetts law requires a utility to sell stock to finance its requirements at not less than par. The result of this has been that the Massachusetts Commission has allowed utilities to earn sufficient money so that their stocks will sell always above par. Professor Barnes says "usually from 20 to 25 points above." (*Ibid.*, p. 154, also pp. 155, 173, 213.)

It is apparent from this statement that however successful the Massachusetts method may be it is not in any sense an application of the method used by the Commission in this case.

California has often been referred to in this Court and elsewhere as the leading exponent of the prudent investment method of regulating rates. We say regulating rates because as will be developed the prudent investment doctrine is not merely a method of determining rate base but a method of determining rates in such a manner as to avoid as many as possible of the troublesome disputes that have plagued rate litigation.

As to the California method it is thus stated by the California Commission:

"During its entire history in establishing reasonable rates for utilities similar to this company, to determine a proper rate base this Commission has used the *actual* or *estimated historical costs* of the properties *undepreciated*, with *land at the present market value*. Consistent with this, it has used the sinking fund method to determine the allowance for depreciation to be included in operating expenses.

"This historical method has dominated the Commission's findings for several principal reasons." (quoted in *Railroad Commission of California v. Pacific Gas & Electric Co.*, 302 U. S. 388, 395.)

As to the reasons for using an undepreciated rate base and the sinking fund method of determining the annual allowance for depreciation expense, the California Commission says:

"As this Commission has frequently pointed out, such conflicts and inconsistencies as have been discussed herein in the treatment of depreciation in rate cases may be avoided by the use of the sinking fund method. No estimate of the highly controversial issue of accrued depreciation is needed in this method, the undepreciated property value being used as the base. The amounts accrued are in most properties, as in this Company, invested in the property and with a reasonable interest return thereon are sufficient to replace the property at the end of its estimated useful life. The method has been followed for many years by this Commission." (*Los Angeles v. Southern California Telephone Company*, 39 Cal. R. Com. 739, 14 P. U. R. (N. S.) 252, 275 (1936).)

It will thus be observed that the rate base is the actual or, if necessary, the estimated historical cost undepreciated with land at market value. On this the full rate of return is allowed. In addition there is included in operating expenses an allowance for depreciation calculated on the sinking fund method.

As to the amount of the annual depreciation allowance, the California Commission has said:

"The depreciation annuity which this Commission found reasonable in 1916 was equal to 1.54 per cent of the rate base excluding materials and supplies and working cash capital. The depreciation annuity which has been allowed by the Commission in the various decisions since then has averaged practically the same amount. The depreciation annuity so determined is based upon a 6 per cent sinking fund and represents the estimated amount which, set aside annually with compound interest at 6 per cent, will be sufficient to cover the original cost of the various units of property at the expiration of their probable life." *San Joaquin Light & Power Corporation*, 21 Cal. R. Com. 545, P. U. R. 1922D 595, 625 (1922).

In more recent cases the allowances have substantially conformed with this 1½% (See *Pacific Gas & Electric Company*, 39 Cal. R. Com. 49, 1 P. U. R. (N. S.) 1 (1933); *Los Angeles v. Southern California Telephone Company*, 39 Cal. R. Com. 739, 14 P. U. R. (N. S.) 252 (1936)).

As to the rate of return the California Commission early adopted this principle:

"The Commission in fixing a rate of return must be liberal, lest too strict a policy result in turning capital to other fields of enterprise. California needs development by public utilities, and this Commission's policy should be a broad and liberal one, so as to encourage capital to develop the state by legitimate public utility enterprises where needed." (*City of Palo Alto v. Palo Alto Gas Company*, 2 Cal. R. Com. 300, 317-318 (1913).)

In applying this policy it has always given great weight to the historical cost to the utility of its capital but has added something to cost for profit. In justification of this the Commission has said:

"In this consideration, the same logic that justifies consideration of the reasonable historical cost of property for a utility such as this one, as the fairer basis for determination of rates, applies as well to the question of fair return. If the reasonable historical cost shall be used as the rate base, then it is apparent that

a fair return determined on the basis of present yield of securities, as suggested by Dr. Maltbie, is not applicable. Greater consideration should be given to the historical cost of moneys, though this alone should not be the measure." (*Application of Pacific Telephone and Telegraph Company*, 33 Cal. R. Com. 737, 772-773, P. U. R. 1930C 481, 513 (1929).)

As to the amount of this return the Commission, writing in 1921, said:

"'The Commission in fixing rates for utilities, such as applicant, has generally found that 8 per cent was a reasonable return under conditions prior to 1918. Since January 1, 1918, money invested in property of this applicant has cost from 7 per cent to 8 per cent, and if a utility is to continue to meet its obligations and attract capital it must be expected that some profit on its enterprise be allowed in addition to the bare cost of the money invested. If we consider a return of 8 per cent as reasonable upon money invested prior to January, 1918, and 9 per cent on the money invested since that time, we find that the average rate of return upon the present investment in operative property in 1921 would be 8.3 per cent, * * *." (*Application of Southern California Edison Company*, 19 Cal. R. Com., 595, 603, P. U. R. 1921D 63, 75.)

Consistent with its theory the California Commission in recent years has fixed a somewhat lower rate of return than formerly although we know of no case in which it went below 7% on the undepreciated historical cost and this in the case of the *Pacific Telephone and Telegraph Company*, 33 Cal. R. Com. 737, P. U. R. 1930D 481 (1929).

Thus the essential features of the California method are these:

(1) An undepreciated historical cost rate base; actual if possible, estimated if necessary.

(2) Annual depreciation expense fixed on a sinking fund method at a sinking fund rate somewhat lower than the rate of return. Thus, the interest charge on the depre-

ciation reserve must be added to the reserve by the utility from its return.

(3) A liberal rate of return somewhat above the historical cost of capital to the utility.

This we suggest is the prudent investment method of regulating rates which Mr. Justice Brandeis advocated in his classic exposition in the *Southwestern Bell Telephone* case. His rate base was to be original cost corrected by historical cost if necessary, and presumably undepreciated since he did not mention depreciation and since his principal object was to avoid as many as possible of the troublesome questions in rate-making. Of equal importance in his mind was the fact that the rate of return was to be determined on the basis of the capital cost of money to the utility and not on the basis of costs current at the time of regulation. (*State of Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission*, 262 U. S. 276, 304-308 (Brandeis, *J.*, concurring).)

As an illustration of the California method we take the case of *Los Angeles Gas & Electric Company v. Railroad Commission*, 289 U. S. 287.[27]

The Commission found a historical cost of $60,700,000. This was made up of a rate base established by the Commission in 1917 "upon a valuation made by the Commission's engineers as of October, 1915" (p. 292) to which was added net additions and betterments as entered upon the company's books. Land was taken at current values (pp. 292-293). ~~No accrued~~ depreciation was deducted. Both the Commission and the company introduced evidence of reproduction cost and accrued depreciation and on the basis of this evidence the Commission found a fair value (undepreciated), of $65,500,000 (p. 298).

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[27] In the dissenting opinion of Mr. Justice Stone in *West v. The Chesapeake & Potomac Telephone Co.*, 295 U. S. 662, at 693, this case was referred to as one in which the California Commission "made its valuation on the basis of prudent investment."

As a depreciation annuity the Commission allowed $1,-072,000 equivalent to 1.7% of the historical cost rate base (p. 303).

By way of return the Commission allowed a sum equal to 7.7% on the historical cost rate base or 7% on the fair value rate base, both undepreciated (p. 292). While the company was engaged in both the natural gas and electric business it was the natural gas property that was involved in this case.

As we develop later in this brief, if the California method were properly applied to Hope its rate base would have been double that used by the Commission and its permissible earnings more than double (*infra*, pp. 114-115). For present purposes we content ourselves with pointing out that the Commission method of regulating rates does not bear the slightest resemblance to the prudent investment method of Mr. Justice Brandeis or as practiced in California. It does not take an undepreciated rate base. It purports to estimate accrued depreciation, and in this case has grossly over-estimated it. It does not recognize the historical cost of money but fixes the rate of return on a basis that is less than current cost of capital to natural gas companies.

The only additional experience cited in the Commission's brief is that of the Commission itself and so far, except for Hope, it has dealt only with companies like its water power licensees or with the western natural gas pipe line companies. All of these properties have been constructed within recent years and at price levels where original cost will approximate a fair reproduction cost.

We submit that there is no experience anywhere under the rate-making method used by the Commission in this case.

(2) **Accuracy**. The Commission argues that its depreciated cost rate base can be determined "expeditiously, accurately, and to a degree of exactness that leaves

substantially little ground for conflict" (Com. Brief, 65). In this case the parties are in violent conflict over original cost and over the determination of accrued depreciation. While here there is no question but that all expenditures were prudently made it is not idle prophecy that violent and prolonged conflict could easily arise over that issue. In fact such an issue appeared in the case of the manufactured gas equipment in the *Los Angeles Gas* case, *supra*, page 72. Indeed the necessity for determining today whether a certain action was prudent at a prior time, from which hindsight cannot be wholly excluded, is bound to result in numerous controversies.

Moreover the dollars that will be set down for original cost with such "delusive exactness"[28] will not state with even remote accuracy the true or economic cost of the property or the sacrifice the owner made to construct it. Certainly the dollar is not what it used to be in exchange value or in purchasing power. Only its symbol remains the same.[29] When, therefore we set down the figures as

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[28] Mr. Justice Holmes in *City of Louisville v. Cumberland Telephone and Telegraph Co.*, 225 U. S. 430, 436.

[29] For nearly 100 years prior to 1933 a dollar was the right to receive 23.22 grains of fine gold. The exchange value of that gold expressed in other commodities has varied widely over the years due principally to fluctuations of other commodities, but to some extent due to fluctuation of gold. In 1933 the quantity of gold in a dollar was changed to 15-5/21 grains, only .9 fine. More recently when specie payment was suspended it ceased to be the right to receive anything in gold. Whether the dollar of the future will be tied to gold or to commodities no one can say.

It is clear that for every dollar Hope spent in the construction of property prior to World War I it gave up the right to demand 23.22 grains of fine gold. The physical properties for which it exchanged this right to gold were placed at the service of the public. What justification would there be for measuring Hope's rights by the fluctuating value of fine gold which Hope exchanged for its property, instead of measuring it directly by the present value of the land, pipe, and other property for which Hope made the exchange? The pipe, not the gold, is devoted to

(*Continued on next page*)

to dollars originally spent in the construction of Hope's property in every year from 1898 to date it gives an appearance of accuracy when in fact it merely represents widely varying exchange values of the dollar over a long period of years.

The truth is that it is no more difficult to estimate with substantial fairness the present value of the property devoted to service than it is to estimate the present economic value of the original dollars that were exchanged for the property. *To use merely the sum of the dollars originally spent, in utter disregard of their economic value, is merely to avoid and not to solve the problem.* Certainly Constitutional protection of property rights disappears if the courts shut their eyes to what every man on the street knows—that the dollar today is worth only 50% of the dollar several decades ago and that the dollar of the future may be worth even less.

(3) **Stability.** The Commission argues that original cost provides a stable rate base (Com. Brief, 66) and that this stability will appeal to investors. We suggest "inflexibility" is a more suitable word than "stability" to describe this attribute.

Rates have been fixed on the basis of present value for about 50 years. We know from this experience that this method has attracted capital to public utility enterprises until today they are more fully developed in the United States than in any other part of the world. The cost of service is lower here than in any other part of the world. Securities of public utilities have attracted both private and

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(*Continued from preceding page*)

public service. But the original cost basis does not even measure Hope's rights by the dollars it exchanged, which represented 23.22 grains of fine gold, nor yet by the dollars represented by 15.15/21 grains of gold, not so fine, but by present day dollars that have much less exchange value than even 15 grains of gold. (See article in forthcoming (October) issue of *Michigan Law Review* by Thomas L. Long of Detroit.)

institutional investors to the extent of many billions of dollars. It would, of course, be as wrong to claim that this is all due to the present value rule as it would be to claim that the present value rule had no part in this development.

One reason, we suggest, for the persistence of the rule through periods of depression and prosperity has been its flexibility. The Commission now proposes to substitute for this an absolutely inflexible rule, to be applied to all utilities, electric, gas or other, old or young, which it is said will always be fair to both consumer and investors and will protect the consumers from paying more than a return on investment and the investors from "depreciation in value during times of depression."

Here is defiance to ordinary economic laws. If deflation occurs and prices go down the utility is still to have a rate base higher than the current value of its property. This can only mean that consumers in such periods are to pay the same dollars as before, although they have fewer dollars and should pay less. On the other hand, if prices rise the consumer is to be protected from paying higher rates even though his wages have risen along with all other prices. This means utilities and their owners, at a time when the consumers are fully able to pay higher rates, must nevertheless suffer.

If we are practical we recognize that over a long period of years, in spite of periods of deflation followed by periods of inflation, the world wide trend of prices has been up. Part of every inflation becomes permanent. But suppose, as many well informed persons now fear, with an already high level of prices we have further serious inflation. In the case of a utility plant it now costs about \$2 to build what prior to World War I was built for \$1 (Ex. 20, R. I, 207, col. (6)). Suppose in the future it takes \$5.

Under these circumstances the rigid rate base based on the \$1 and \$2 costs would effectively destroy a large part

of the present investment in the public utility industry. There is no way out. If the owners of utility equities—and this includes not only millions of private investors but insurance companies, banks, colleges and other institutional investors—are only permitted the opportunity to earn on the number of dollars originally invested at a time when those dollars have only 1/5th or 2/5ths of their former purchasing power, the effect will be to reduce the value of all such investments by 4/5ths or 3/5ths.

The truth is that this so-called "stability" in the original cost rate base is not a virtue but one of its most serious vices. It is a strait-jacket, which is never a cure.

Public utilities in the future will have to do business on the basis of the future value of the dollar. It is these dollars that they will collect from their customers and that they will use for the payment of wages, operating expenses, taxes and other charges. It is with these dollars that they will have to replace worn out property. If replacement costs are two or three times original cost and the utility's annual allowance for depreciation has been based only on original cost, then the utility must either sell capital securities merely to keep going, if it can, or face bankruptcy. Under such circumstances there is not the slightest justification for requiring the owners of utilities to get a return based on pre-World War I dollars or on any other than those currently in use in the commercial world.

Plainly a strait-jacket on a rate base in an economic system where prices and values are constantly fluctuating is neither desirable nor reasonable.

(4) **Investor Appeal.** The Commission argues (Com. Brief, 66):

> "A basis of rate regulation which maintains the Company's financial integrity and permits it to raise the required capital cannot be deemed arbitrary."

No support of any kind is given for this assumption as to financial stability except a reference to practical experience

in California and Massachusetts. As we have seen, *supra*, pages 67 to 73, the method of rate regulation in California and Massachusetts is so wholly unlike anything the Commission has done in this case that successful experience there gives no support to the Commission's theories in this case.

The Commission's statement, however, recognizes what this Court has always recognized, namely that any scheme of rate regulation that will not continue to attract private capital to public utilities is unreasonable and must fail.

We know from long and successful experience that the present value rule has attracted capital to public utility enterprises at reasonable costs. What assurance does the Commission's method as applied in this case give that it will continue this record?

To simplify the problem let us consider the position of an individual who is contemplating the construction of a public utility. He will be told that that part of his dollars afterwards judged to have been "legitimately" spent will be included in the rate base; that the rate base will never reflect changes in price levels either up or down; and that on that rate base he will be entitled to receive a return and an allowance for depreciation, if successful operation permits rates high enough to cover those amounts. According to the further theory of the Commission in this case, when the total depreciation charged equals the cost of the property he will thereafter no longer be entitled to any return or depreciation (Com. Brief, 83, 105-106).

What he will be told about the measure of the rate of return is not clear. The Commission's brief advocates a rate of return based on "current costs of capital" on page 66, but in a note on page 67 it says:

> "And if some account must be taken of the factor of increasing prices as bearing upon the instability of investment, this may readily be accomplished by altering the rate of return."

In the present case, however, the Commission actually fixed a low rate of return on the basis of current costs of capital and disregarded the greatly increased price level.

Thus on the Commission's theory as here applied (1) the utility owner will be permitted, if he can, to earn a return on the dollars invested, less accrued depreciation, and (2) at a rate of return based on future money market conditions. The utility owner has not the slightest chance for a profit to compensate him for the risks of loss that he runs.

He is asked to lend his money without any obligation or security for the payment of interest (return) or for the repayment of principal. He will get his return and a restoration of that part of his investment "legitimately" made only if the enterprise is successful. By no possibility can he get more than his investment, plus return and he may lose it all as did many investors in interurban and street railways.

It does no good to argue that a public utility with a return of 6½% can issue bonds at 3% and thus pay a much larger return upon its common stock. Every dollar issued in bonds increases the risk of the common stock and so increases the return necessary on it. The rate of return is fixed having in mind the over-all cost of capital to the particular utility including money raised by the sale of bonds and the sale of preferred and common stocks. For purposes of present argument we must assume that the rate will fairly represent the composite risk of all. So considered this Commission theory assumes that an investor in common stocks will accept the terms of a bond *minus* the security that a bond offers and *minus* any obligation either to return his money at any time or to pay a stipulated return.

He can not even contemplate a continuance of the rate of return upon the basis of which he was originally asked to supply funds. His unsecured investment is subject to the still further risk of a future reduction in rate of return

based on then current money rates, which when applied to a then depreciated dollar gives him but a fraction of the economic return he anticipated when he originally advanced his more valuable dollar.

That money, particularly equity money, will not continue to flow into public utility enterprises on any such bases seems too obvious for controversy. Commissions and courts can control rate base, rate of return and allowable operating expenses, but they cannot control the economic laws that regulate the flow of money into new or old enterprises. If the terms they impose are not satisfactory to the investing public the money will not be forthcoming. It will go into other channels.

There is no experience that indicates, and there is not the slightest ground for the belief, that private investors will continue to supply the equity money for public utilities whose rates are regulated on the theory here applied by the Commission. The imposition of any such method of rate regulation as here advocated in the end means either government financing or government ownership of public utilities.

D. THE COMMISSION ARBITRARILY DEDUCTED IN ITS RATE BASE MORE FOR ACCRUED DEPLETION AND DEPRECIATION THAN EXISTED IN FACT.

(*Com. Brief, 89-99; Cleve. Brief, 46-52*)

As we have seen, the prudent investment method of rate making as employed in Massachusetts and California does not call for deduction of accrued or existing depreciation in determining the rate base. Such a deduction is of course a necessary step in determining the present value of utility property (R. IV, 189) which the Commission never undertook to do. Nevertheless it did make a large deduction for accrued depreciation (Opinion, R. I, 36).

Both the petitioners state the fundamental question on this point to be whether the Commission's "method" of determining actual existing depreciation is reasonable

(Com. Brief, 4, 89; Cleve. Brief, 8, 20, 47). The true issue obviously is the reasonableness of the Commission's *results,* as the Circuit Court of Appeals held (R. IV, 189-193). Anything deducted by the Commission in arriving at its rate base in excess of the depletion and depreciation existing in fact in Hope's properties plainly confiscates them.

There was no disagreement between the parties as to the underlying principles of depreciation that should be applied: that true depreciation is the extent to which the service or economic life of the property has been consumed, and that accrued and annual depreciation must be harmonized. The petitioners' general discussion of these principles is purely of academic interest, since all parties agreed upon them and Hope applied them.[30]

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[30] This was clearly developed at the hearings:

"The Witness: [Rhodes] Well, in general, the methods followed by the Commission and the methods followed by me differ only as to the order of procedure. The Commission first found depreciation rates—

By Mr. Cockley:

"Q. (Interposing) You mean the Commission's Staff?

"A. Yes, the Commission's staff first found rates of depreciation, and then from these rates of depreciation they computed accrued depreciation of the property.

"In my work I determined directly the accrued depreciation in the property, and I computed the rates of depreciation required by the Company to meet its losses.

"Both methods, when correctly applied, use accepted accounting procedure.

"Q. Now will you tell us why you chose the method you did, rather than the method that the Commission used or the Commission's staff used?

"A. There were a number of reasons for my choice, the principal one of which was that since I was primarily interested in determining accrued depreciation in the property, I determined it directly from measured and observed facts.

"The Commission's method is based upon determining service life, largely a matter of judgment not supported by facts in the Company's experience. There is no mortality experience that means much in property such as Hope's natural gas property.

(*Continued on next page*)

This Court has already called attention to the inherent difficulties of determining actual accrued depreciation by the Commission's roundabout method of estimating service lives and then using them to compute a depreciation reserve. In *Lindheimer v. Illinois Bell Telephone Company*, 292 U. S. 151, 168, it said:

> "If the predictions of service life were entirely accurate and retirements were made when and as these predictions were precisely fulfilled, the depreciation reserve would represent the consumption of capital, on a cost basis, according to the method which spreads that loss over the respective service periods."

It then went on to say that the burden of showing the correctness of the depreciation allowances arrived at by the Telephone Company on that method—

> "* * * is not sustained by proof that its general accounting system has been correct. The calculations are mathematical but the predictions underlying them are essentially matters of opinion. They proceed from studies of the 'behavior of large groups' of items. These studies are beset with a host of perplexing problems. Their determination involves the examination of many variable elements, and opportunities for excessive allowances, even under a correct system of accounting, are always present. The necessity of check-

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"Furthermore, in starting from a judgment figure, the computing of the accrued depreciation in the property magnifies any errors in accounting procedure or any difference between the accounting procedure followed by the Company and that which somebody now thinks it should have followed.

"When accrued depreciation in the property is directly determined from the property itself, the property and the condition of the property is the test of the method; *but when the depreciation in the property is calculated by the roundabout method of judging as to the service life and going through 40 years of accounting records, the only test of the correctness of the Commission's result is whether or not it compares with the facts which can be found by examining the property.*

"I ascertained those facts first, by my method, and that is the reason I chose it." (Tr. 5239-5241).

ing the results is not questioned. The predictions must meet the controlling test of experience.

"In this instance, the evidence of expert computations of the amounts required for annual allowances does not stand alone. In striking contrast is the proof of the actual condition of the plant as maintained— * * *." (292 U. S., 169-170.)

This Court then concluded that the annual depreciation charges determined by that straight line method and the resulting depreciation reserve were erroneous, when so tested by comparison with the actual condition of the plant—"in the face of the disparity between the actual extent of depreciation, as ascertained according to the comprehensive standards used by the Company's witnesses, and the amount of depreciation reserve" (292 U. S., 174-175).

This necessary check upon the *results* reached by the Commission's Staff was never made. The various Staff members worked separately on the various separate parts of the formula set up for them to follow (*supra*, pp. 26 to 27). No Staff witness reviewed the results and testified that they in fact reflected accurately the accrued depreciation and depletion now existing in Hope's property. This is astonishing but true. A check of results would of course have disclosed the errors in service lives and of application of the method (*supra*, pp. 26 and 27) which produced the arbitrary results next referred to. All any of the Commission witnesses ever claimed is that the general *method* they used was a good one, and this is all the briefs of the petitioners say here.

Had the Commission checked the *results* of its Staff's work, as the court below did, instead of being concerned only with general principles and general methods (Opinion, R. I, 36-46), it would have discovered the following among other grossly arbitrary and unreasonable results:

(1) Hope's well equipment, having an adjusted book cost of $7,610,510 at the end of 1938, the Staff depreciated

to a net book cost of $3,227,807 (Ex. 61, R. III, 189, 191). Only 42.4% of the book cost thus went in the rate base. This is less than the salvage value of that equipment, which over the past ten years has amounted to 65.2% of the book cost (Ex. 21, 4-5). *In other words, the Staff wrote down the book cost of Hope's well equipment to less than two-thirds of its salvage value as established over a long period of years.* So gross was this error that the Commission in its Opinion corrected it in part by recognizing that the depreciation rates used in its calculations were excessive and, consequently, reducing its "Accrued Depreciation" by $566,771 (Opinion, R. I, 44). However, even after this partial correction the Commission's "rate base" for Hope's well equipment is only three-fourths of the book cost of the salvage which Hope has been obtaining from its wells.[31]

This "rate base" is of course an even smaller fraction of the salvage of well equipment in terms of present prices.

(2) In the case of field line equipment having a book cost of $7,934,169 at the end of 1938, the Commission's "accrued depreciation" deducted from its adjusted book cost leaves a net book cost or "rate base" of only $4,088,602, or 51.5% of the book cost (Ex. 61, R. III, 189, 191). Hope's actual experience in gross salvage of field line equipment has been 56.7% over the past ten years (Ex. 24, 26). *Thus the Commission has written down all of Hope's field line pipe to less than the gross salvage value of this pipe on a book cost basis as established by Hope's actual experience.*

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[31] Actually after deduction of the Commission's hypothetical reserve for future well abandoning costs, *infra*, pp. 86-87, the Commission allowed in Hope's rate base only $1,687,300 or 22.2% of its adjusted book cost of Hope's well equipment for 3300 wells. This amount compares with Hope's $6,133,000 or 56% net present value after deducting well abandoning costs (Ex. 124, R. III, 204), with which Cleveland's brief (pp. 50-51) says comparison should properly be made.

On the basis of current pipe prices, rather than the prices Hope paid years ago, the Commission's "rate base" for field line pipe would, of course, be very substantially less than the present salvage value of this pipe.

(3) In the case of compressor station equipment having a book cost of \$7,683,672 at the end of 1938, the Commission has deducted "accrued depreciation" so as to leave a net book cost or "rate base" of \$4,579,853, or only 59.6% of the book cost (Ex. 61, R. III, 192, 194). Hope's actual experience in gross salvage on compressor station equipment has averaged 56.4% over the past ten years (Ex. 24, 29). *Thus, the Commission has used as a rate base for Hope's compressor station equipment only a few dollars more than the gross book salvage value of this equipment.*

On the basis of the higher current prices for compressor station material it is obvious that the Commission has used no more than salvage value for this equipment.

(4) On properties purchased by Hope from prior utilities the Staff and the Commission assumed, without any investigation, that whatever depreciation reserves the prior utilities had set up on their books accurately represented the accrued depreciation on those properties as of the date of their purchase by Hope. By using these reserves as set up by predecessor utilities *instead of reserves accumulated at the Staff's own annual depreciation rates applied to these purchased properties*, the Staff, and the Commission in its Opinion, overstated its "Reserve Requirement" or "Actual Existing Depreciation," and understated its "rate base," by \$743,927 (Ex. 137, 3, Tr. 2917, 6502).

(5) On communication equipment, i.e., telephone lines and equipment, having an adjusted book cost as of the end of 1938 of approximately \$250,000 the Staff, and the Commission in its Opinion, deducted an "Adjusted Depreciation Reserve" of \$185,000. It was admitted by Commission witness Dunn that this reserve was sufficient to take care of all the past retirements of communication equipment

property that had ever occurred over Hope's entire history from 1898 on (Tr. 3781-3782), and that if he had been able to get all of the actual retirements in the past he would have deducted them from his computed reserve, but these figures not being available he did not do so (Tr. 3782-3783). In other words his "accrued depreciation" includes the depreciation not only in the existing property but in all of the property of this sort Hope has ever had, including that retired from service during the past 40 years.

(6) The Commission deducted from the book cost of Hope's properties as a part of its "Adjusted Depletion Reserves" the sum of $2,107,261 for what is labeled "Cost of Abandoning Gas Wells" (Ex. 61, R. III, 188). This cost is one that is incurred by Hope for cementing in and plugging wells in accordance with West Virginia laws at the time they are abandoned. The cost of this is an operating expense when abandonment occurs and has nothing whatever to do with depreciation or depletion of book costs or any other costs as the Staff admitted (Dunn, R. II, 512-513).

The $2,107,261 represents a hypothetical reserve which the Commission claimed Hope should have set up in the past for the future cost of abandoning *all* of its present 3300 gas wells. It was not limited to the 772 wells whose drilling cost was included in the Commission's adjusted book cost. The Commission has thus in this instance reversed Hope's former accounting practice and set up a capital account in place of an operating expense.

From the very beginning of operations Hope, in accordance with accounting practice that was admittedly good then and still is (Dunn, R. II, 512), charged the cost of abandoning gas wells to operating expenses when wells were actually abandoned (R. II, 511-512). In fact it was required so to do by the 1923 West Virginia code of accounts (R. II, 511-512) and until West Virginia's present code became effective in 1939.

Nevertheless, because the Commission's new Uniform System of Accounts now requires that a reserve be set up each year for future well abandoning costs, the Staff assumed that Hope should have set one up for this purpose in the past (R. II, 515, 518). In this case Hope's past accounting practices as to all well abandonments are not to be "frozen," although as to well drilling costs they are (*supra*, p. 41). Here again is an inconsistency by the Commission in applying its accounting theories which is arbitrary and unreasonable.

Of course in determining the present value of property the economic encumbrance of future abandoning costs must be recognized and the Circuit Court of Appeals, we believe, properly so held (R. IV, 192-193). In determining the present value of Hope's approximately 3300 wells Hope did deduct future abandoning costs from the present depreciated value of the equipment in these 3300 wells. But the Commission's rate-fixing method is not concerned with property now in existence or with present day values— hence it should not have been concerned with this encumbrance on present value.

It will be observed that the Commission's brief does not attempt to defend the results reached by the Commission. Instead, it is stated in a footnote (p. 94) that the Circuit Court of Appeals overlooked the inspection of Hope's properties made by Commission engineer French as an aid in arriving at his estimated service lives. This inspection was called to the court's attention in the Commission's brief before that court (p. 58), but the court knew from the record that neither Mr. French nor any other Commission witness ever testified that the Staff's results in fact reflected the actual depreciation in Hope's property as checked by this inspection or any others.

There is also a footnote criticism (Com. Brief, 95) of the Circuit Court of Appeals' use of the term "salvage value." The fact is that the court used this term precise-

ly in accordance with the Commission's own Uniform System of Accounts which defines it as follows (Ex. 58, R. III, 44):

> "34. 'Salvage value' means the amount received for property retired, less any expenses incurred in connection with the sale or in preparing the property for sale, *or, if retained, the amount at which the material recoverable is chargeable to Account 131, Materials and Supplies, or other appropriate account.*"

Thus the Commission specifically directs that recoverable material *retained* by a gas company in connection with "property which has been *removed*" be treated as salvage—which, of course, it is.

The point involved is not, however, one of definition but of practical conception of what result the Commission reached. The Commission wrote down *all* of Hope's existing well equipment for 3300 wells, and its 3000 miles of field line pipe to substantially less than the book cost of that *part* of all this well equipment and line pipe which Hope's actual experience shows will be in perfectly suitable condition for re-use, either by Hope or other people, many years in the future when the existing wells are abandoned and the existing field lines taken up (Ex. 21, 4). On compressor station equipment it did not go quite this far, but very nearly.

The Commission's brief also argues by footnote (p. 94) that "The depreciation rates are not applied to the original cost of the property, but rather against its 'service value'," namely original cost less salvage value. Hence it is a "mathematical impossibility" to arrive at a net book cost less than "salvage value." The writer of this footnote was not familiar with the record, because the Commission's Staff did apply its depreciation rates directly to the "Adjusted Book Cost," computing them "on the average investment for the year" and did not apply them to the "service value" of Hope's properties (Dunn, Ex. 61, R. III, 181; French, R. III, 172-173).

Both the Commission and Cleveland argue that this Court's decision in *Federal Power Commission v. Natural Gas Pipeline Co.*, 315 U. S. 575, somehow supports what the Commission did on accrued depreciation in this case (Com. Brief, 96; Cleve. Brief, 48-49). In that case depletion and depreciation of properties in a continuing business such as Hope's were not involved at all, but rather amortization on a sinking fund basis for "a business which can exist for only a limited time"—23 years in all from the beginning to the end of the business (315 U. S., 593, 594). The very question involved here—how much of the total service life of Hope's existing properties has *in fact* expired—was agreed to by the parties for the properties involved in the *Natural Gas Pipeline* case. There the beginning was admittedly 1932, the end admittedly 1954, and the present date an obvious fact (315 U. S., 578, 580, 593).

Concluding, we repeat. Neither in this Court, in the Circuit Court of Appeals, nor before the Commission has anyone claimed that the *results* reached by the Commission's Staff and the Commission *in fact* represents the accrued depreciation and depletion existing in Hope's properties. We also note that although the Commission's Staff worked a year after Hope's accrued depreciation study was presented and had available all of Hope's underlying data before presenting its own depreciation and depletion calculations (Tr. 879; R. II, 44; Tr. 3245), not one single Staff witness, engineer or accountant, either by written exhibit or orally, on either direct or cross examination, ever undertook to state that the results reached by Hope's witnesses did not in fact reflect fully the accrued depreciation and depletion actually existing in Hope's property. The plain truth is that Hope was subjected to the blind application of a depreciation formula, inherently requiring a check of results, whose actual results the Staff never checked and the Commission did not choose to check.

The Circuit Court of Appeals was clearly right in condemning the results in this case as arbitrary (R. IV, 189-193).

E. SUMMARY AND CONCLUSIONS AS TO RATE BASE.

As we have seen, the Commission's rate base in this case:

(1) Does not reflect any change in price levels since 1898 and understates by many millions of dollars the present value of Hope's property judged by any reasonable standard (*supra*, pp. 53-54);

(2) Does not include a substantial portion of Hope's properties now actually in service (*supra*, pp. 30-35);

(3) Does not set forth a rate base such as would be determined in California where the prudent investment theory has been practically applied (*supra*, pp. 67-73);

(4) Eliminates a large portion of the other properties by finding that the depreciation therein is substantially in excess of what it is in fact (*supra*, pp. 80-89); and

(5) Applies inconsistent accounting principles to its determinations of rate base and operating statements with the result of understating the rate base and so the cost of gas service (*supra*, pp. 42-46, 86-87).

This Commission rate base which neither represents the property in service nor the cost of this property, nor its present value, is one the like of which has never heretofore appeared in any decision. Probably the nearest approach to it is the District Court's rate base in *West v. The Chesapeake & Potomac Telephone*, *supra*, where it took merely book cost and deducted the book depreciation reserve, a rate base which this Court tersely condemned as arbitrary. 295 U. S., 678-679.

Actually the Commission's method results in a mere bookkeeping rate base. It ignores present property for past bookkeeping. It converts present physical property and property rights of the utility into mere claims to book-

keeping entries which the Commission's accountants and the Commission, in their own judgment, may decide are not "accounting errors" of the past. If generally applied this bookkeeping theory of rate making would produce grossly inconsistent, inequitable and arbitrary results, just as it has in this case.

For example, Company A's books have been kept for the last 40 years on the principle of capitalizing every item that could possibly be capitalized under accounting rules. Its depreciation reserves have been kept down to a minimum. This has enabled it to pay out large dividends on the largest amount of capital stock that could be issued. Company B on the other hand, the Hope Company, has followed a directly opposite principle. It declared no dividends for the first 10 years (Ex. 81, R. III, 13) of its history and plowed earnings back into the property. It has set up large depreciation reserves when its earnings were good, instead of paying dividends, not only to preserve but to develop its property. Its outstanding capital securities are less than half of its value as assessed for taxation by West Virginia. But on the Commission's theory because of its conservatism and the careful management of its financial affairs in the past Hope is now to have a rate base substantially less than Company A. Sound, conservative and thrifty business practices are to be punished.

Again, let us assume that the Hope properties belong to two separate companies, that Company X owns the one-half of its properties constructed prior to 1917 and Company Y owns the half of its properties constructed since that time. Company X would have an original cost of $25 million, Company Y an original cost of $45 million (*supra*, p. 22). Moreover Company X, being older, would have a higher per cent "depreciation reserve requirement" than Company Y. The result would be that on the Commission's theory Company X would have a rate base of less than half as much as Company Y and its rates would be substantially lower. It is certainly an arbitrary result if

two companies with like properties performing a like service with a like commodity in the same locality have widely different rates. They would have, however, if their rates were fixed by this Commission on its present bookkeeping theory.

In addition the application of this bookkeeping theory rests upon someone's notion as to what was proper accounting in the past and what is proper accounting now. As to this no two accountants have ever agreed—or will. Yet, as illustrated in this case, millions of dollars can be deducted from the rate base because the Commission's present chief accountant believes that well drilling costs are capital expenditures, rightly considered, but also believes it was not an "accounting error" to expense them in the past. Present property rights cannot, except arbitrarily, be allowed to rest on shifting notions of what is proper bookkeeping.

Moreover, this bookkeeping theory necessarily regulates retroactively. Here it has had the effect of determining that nothing is allowed in the rate base for many properties actually existing and in service—and costing and having a present value of many millions of dollars because in the years back to 1898 and long before the Natural Gas Act was even thought of Hope did not capitalize these properties on its books. Hope is thus now penalized millions of dollars because it kept its books in a particular way in the past. Had it kept its books less conservatively—on modern accounting notions—or if it had kept no books at all, it would not be subjected to this enormous penalty. The Natural Gas Act was certainly never intended by Congress to permit the Commission to impose enormous penalties by way of rate base deductions on natural-gas companies because they kept their books one way or another in the past—and to penalize particularly those companies which in the past kept their books most conservatively.

All of this arbitrary action by the Commission has followed in this case from its substitution of its own arbitrary

and untried bookkeeping rate base and rate making theories for the plain requirements of the Natural Gas Act and the Constitution that natural-gas companies must at least be permitted a fair return upon the present fair value of their properties.

II. OPERATING EXPENSES.

(Com. Brief, 99-110; Cleve. Brief, 52-55)

To a very large extent there was no disagreement as to Hope's actual and necessary operating expenses.[32] However, the Staff did, as it phrased it, "disallow" certain items or parts thereof. The Commission in its Opinion did not consider the 1937 and 1938 operating expenses included in the record but did find what it claimed were Hope's necessary operating expenses in 1939 and 1940 and projected future operating expenses on the basis of 1940 alone. In these findings it followed the Staff's "disallowances" and understated or eliminated Hope's operating expenses in substantial sums.

The evidence and the Commission's action on disputed items were as follows:

A. ANNUAL ALLOWANCE FOR DEPRECIATION AND DEPLETION.

(Com. Brief, 99-108; Cleve. Brief, 52-54)

1. Property In Existence In 1940.

Hope's determination of necessary annual depreciation was based on annual rates developed on the basis of a careful study of the entire depreciation experience of Hope from 1898 to date (Ex. 24, R. I, 465-477). Hope's method

[32] Hope's annual operating expenses for each of the years 1937 through 1940 were set forth as claimed by Hope in Exhibits 37, 126 (R. I, 479) and 130 and as claimed by the Commission's Staff in Exhibits 67 (R. III, 224), 67A (R. III, 258), 78 (R. III, 287) and 90 (R. I, 493 and R. III, 349) and in Commission counsel's briefs before the Commission.

served to correlate completely accrued and annual depreciation. As stated by Mr. Rhodes (R. I, 475):

> "These annual rates of depreciation as heretofore stated are determined from the Company's actual depreciation experience over the entire history of its properties and correlate annual depreciation with the accrued depreciation deducted in the Company's exhibits from reproduction cost new. * * *"

We call attention to this testimony because of the wholly erroneous and unfounded statement in the Commission's Opinion (R. I, 37) that Hope presented inconsistent claims on accrued and annual depreciation.

The Commission's Staff used the annual depreciation rates estimated by Commission engineer French (Ex. 65, R. III, 151). On the important property accounts these estimated annual rates were in fact larger than those determined from Hope's study because of the short service lives erroneously estimated for these properties (*supra*, pp. 26-27). The basic reason for the Commission's inadequate annual depreciation expense is, therefore, not in the annual depreciation rates used by the Commission but in the base to which they are applied.

Hope applied its rates to the present value of *all* of its properties (Ex. 24, R. I, 467), whereas the Commission applied its rates to its "Adjusted Book Cost" (Ex. 61, R. III, 175, 181). Since this adjusted book cost excluded the original cost of $17,000,000 of property owned by Hope and presently in service (*supra*, pp. 20, 33), the Commission allowed $0 for the actual depreciation and depletion occurring in these properties each year. Hope is thus compelled to sell off this property each year for nothing. Such action is arbitrary and obviously confiscatory.

In applying its depreciation and depletion rates to the book cost of the other property rather than to its present value the Commission of course defied the decision of this Court in *United Railways and Electric Company of Baltimore v. West*, 280 U. S. 234, where it said at pages 253-254:

"The allowance for annual depreciation made by the commission was based upon cost. The court of appeals held that this was erroneous and that it should have been based upon present value. The court's view of the matter was plainly right. One of the items of expense to be ascertained and deducted is *the amount necessary to restore property worn out or impaired, so as continuously to maintain it as nearly as practicable at the same level of efficiency for the public service.* The amount set aside periodically for this purpose is the so-called depreciation allowance. *Manifestly, this allowance cannot be limited by the original cost, because, if values have advanced, the allowance is not sufficient to maintain the level of efficiency.* The utility 'is entitled to see that from earnings the value of the property invested is kept unimpaired, so that at the end of any given term of years the original investment remains as it was at the beginning.' *Knoxville v. Knoxville Water Co.,* 212 U. S. 1, 13-14. This naturally calls for expenditures equal to the cost of the worn out equipment at the time of replacement; and this, for all practical purposes, means present value."

The Commission and Cleveland urged upon the Circuit Court of Appeals that the decision in *Lindheimer v. Illinois Bell Telephone Company,* 292 U. S. 151, justified the Commission's action and the Commission argues here (Com. Brief, 103-104) that it "modifies the contrary holding in the earlier *West* case, 280 U. S. 234." What this Court actually held in the *Lindheimer* case we have already pointed out, *supra,* pages 82 to 83. We add only that what Mr. Justice Butler said in his concurring opinion in that case (292 U. S. 151, 176) was that the Telephone Company's practice of calculating depreciation charges on the straight line method applied to cost less salvage was not in harmony with the *West* case. The Circuit Court of Appeals obviously analyzed the *Lindheimer* decision correctly (R. IV, 195).

It might be noted that the *Lindheimer* case presents the converse of the present case. There depreciation

charges calculated on book costs produced current annual allowances far larger than necessary to reflect the current consumption of property at present values. This Court accordingly condemned them for rate fixing purposes. Here depreciation charges calculated on partial book costs reflecting low price levels of long ago produce current annual allowances far less than necessary to reflect the current consumption of property at present values. The Circuit Court of Appeals properly condemned them for rate fixing purposes.

It was also urged upon the Circuit Court of Appeals, as again here (Com. Brief, 101-103; Cleve. Brief, 52-53), that the Commission's action in calculating depreciation allowances on partial past costs was justified by the decision in the *Natural Gas Pipeline* case, 315 U. S. 575.

In that case the utility was not satisfied with an ordinary depreciation allowance based on the complete consumption of the property in public service. It claimed instead a larger allowance by way of an amortization charge to replace the property in 23 years. The larger allowance by way of amortization was given to it but was limited to the utility's investment. That the decision is confined to a property of limited life is clearly apparent from the opinion (315 U. S., 593).

In the present case no amortization allowance was claimed by Hope or allowed by the Commission, but only the usual depreciation and depletion allowance. Both Hope's engineers and the Commission's Staff treated Hope as the continuing property it is. In such a continuing property the function of a depreciation allowance is, in the language of this Court in the *West* case, to provide the utility with funds "necessary to restore property worn out or impaired so as continuously to maintain it as nearly as practicable at the same level of efficiency for the public service." Since the great and permanent increase in price levels following World War I, Hope can no longer replace at the cost of its

original construction property worn out in service and retired. On the average its replacement cost will now be at least 50% above its original cost. Unless Hope's earnings are sufficient to enable it to make these replacements at present prices the only alternative is to issue and sell, if it can, capital securities to raise money for that purpose. It must either do this or gradually let its properties disintegrate.

All this was stated more succinctly by Judge Parker (R. IV, 194-196).

Against this sound and common sense view of the court below the Commission's brief argues (pp. 102-103) that Hope and the company involved in the *Natural Gas Pipeline* case are really just alike, and the limited principle applied in that case should also be applied to Hope, because (1) Hope will be forced out of business it if does not extend its pipe lines as contemplated and (2) the *Natural Gas Pipeline* Company may continue in business after 1954 if it obtains more gas. With over 700,000 domestic consumers dependent upon Hope (*supra*, p. 5), Hope must and will continue in business so long as there is natural gas in the Appalachian area or elsewhere within transportation range in the United States. Whatever actually happens to the *Natural Gas Pipeline* Company, the Commission's rate determinations and this Court's ruling were made on the basis that "the business, by hypothesis, will end in 1954."

Next the petitioners argue that constitutional requirements are met because the Commission's annual allowances will "reimburse Hope to the amount" of its "existing investment," that Hope is "therefore made whole and the integrity of its investment maintained," and that it "ceases to have a right to a return upon the portion of the investment which has been consumed, and which is recouped from the rate payers through revenues covering annual depreciation allowances" (Com. Brief, 105-106). Here in one paragraph is the whole erroneous theory.

Hope's true "existing investment" is its existing properties. It owns nothing else. It is these properties that the Constitution protects. It is these existing properties that wear out in service and must be replaced. If Hope is not allowed sufficient money in operating expenses to replace these existing properties as they wear out at whatever the actual current cost of replacement is, "the integrity of its investment" is not, as a matter of fact, maintained, nor is Hope "made whole."

What the writer of the Commission's brief means by "existing investment" is not existing property but what it cost—or rather that part of the cost which the Commission has recognized—when installed. Cost, however, the Constitution does not protect. "The public have not underwritten the investment" (Mr. Chief Justice Hughes in *Los Angeles Gas & Electric Corp. v. Railroad Commission of California*, 289 U. S. 287, 306). Cost, moreover, is not a stable thing. It only appears so because it is expressed in dollars and the symbol for $1 in 1898 or 1940 is the same. The pre-World War I dollars which were spent in building half of Hope's existing property were worth twice as much as the post-World War I dollars which were spent to build the remaining half. Thus when in 1942 Hope receives $1 by way of a depreciation allowance to replace pre-World War I property which then cost $1 to construct, it is as a matter of cold, hard sense getting only ½ of its "existing investment" in that pre-World War I property.

Finally the petitioners argue that to compute depreciation charges on cost is the accepted business and accounting practice (Com. Brief, 106-108). That is so as a matter of practical convenience. Hope did so as a matter of convenience even before its accounting was regulated. But business men are free to adjust their depreciation rates so that their annual depreciation allowances will not understate the actual consumption of their properties measured in terms of the existing, not the past, value of the dollar, just as Hope did.

The fundamental business reality, which business men do and the courts have always recognized is that the dollar has a shifting value with a long run tendency to depreciate. Unless this is recognized in determining the annual depreciation expense for rate making purposes property is consumed in service without compensation. This is confiscation.

2. Property Added In 1941 and 1942.

The Commission failed to allow Hope annual depletion and depreciation on the property added after 1940 and in service by July 15, 1942 when its rate order became effective. The Commission estimated this added property at $1,392,021 although Hope claimed it was considerably more (R. IV, 193). The court below was obviously correct in condemning this arbitrary action by the Commission (R. IV, 196).

The Commission's brief by footnote 53 (p. 108) argues that the Commission was not required to make any allowance for *future* capital additions under the *Natural Gas Pipeline* case, and it therefore conferred a "benefit" on Hope, and that Hope "can hardly demand the additional boon of a depreciation allowance on this gratuity." Of course the Commission's allowance was no gratuity. The Commission included in its rate base only one-half of its estimated net increase in Hope's properties for the period 1941 through 1943 thus arriving at the additional property in service when its rate order became effective in the middle of 1942 (Opinion, R. I, 47; R. IV, 193). In the *Natural Gas Pipeline* case the Commission allowed capital additions to the end of 1942 although its rate order was to go into effect in 1940 (315 U. S., 587, 580).

B. ALLOWANCE FOR RETURN ON HOPE'S WEST VIRGINIA DISTRIBUTION PROPERTIES.

In allocating costs for the purpose of testing and fixing Hope's interstate rates the Commission allowed Hope a 6½% return on a rate base for its West Virginia distribu-

tion properties which it determined as follows: It took Hope's \$3,109,994 book cost of these properties and deducted Hope's \$1,393,107 book depreciation reserve therefrom to arrive at a rate base of \$1,716,887, to which was added working capital of \$150,000 (Ex. 90, R. III, 358).

Thus the Commission used as a rate base for all of Hope's West Virginia distribution properties exactly the rate base used by the District Court in *West v. The Chesapeake & Potomac Telephone Co.*, 295 U. S. 662, 668, 678, and as to which this Court said "This rough and ready approximation of value is as arbitrary as that of the Commission, for it is unsupported by findings based upon the evidence." (295 U. S., 679).

Here the record showed that a considerable portion of these properties was built at the low price levels prevailing before the end of World War I (Antonelli, Tr. 5060-5061). Also the Commission itself demonstrated that Hope's book depreciation reserves did not measure the actual depreciation on any basis. Finally, evidence was submitted that the distribution properties valued by the Commission at \$1,716,887 were valued by West Virginia in 1941 for property tax purposes at approximately \$2,859,000 (Chisler, Tr. 5433), but the Commission refused to receive this evidence (Tr. 5416).

The Circuit Court of Appeals was clearly correct in condemning this action of the Commission (R. IV, 197-198) and the petitioners do not undertake to support it here.

C. THE COMMISSION'S EXCLUSION FROM 1940 OPERATING EXPENSES OF \$165,963 FOR AN EXPERIMENTAL DEEP-TEST WELL.

(Com. Brief, 109-110; Cleve. Brief, 54-55)

It is claimed (Com. Brief, 108-109) that Hope was not harmed by the Commission's exclusion of Hope's actual 1940 expenditures (not booked until 1941) in drilling a deep-test well which proved dry and which exclusion the Circuit Court of Appeals disapproved (R. IV, 198). Obvi-

ously Hope was directly harmed to the extent of $165,963 in the Commission's retroactive findings as to what rates it should have charged in 1940 which were based on its actual operations as the Commission found them for that year alone. The retroactive rate fixing of the Commission was overlooked by the writer of the Commission's brief at this point.

Actually Appendix B, Table 1, to the Commission's brief shows the exact extent to which Hope has been harmed by this Commission action. It shows Hope's "Exploration and dev. costs" per books for 1940, 1941 and 1942, which compares with the Commission's allowances as follows (Opinion, R. I, 65):

Year	Exploration and Development Costs: Per Books	Exploration and Development Costs: Allowed by the Commission
1940	$ 427,233	$ 407,920
1941	761,568	600,000
1942	552,704	600,000
Total	$1,741,505	$1,607,920

Thus Hope would actually be deprived of over $133,000 of its actual exploration and development costs if all of the Commission's orders and findings were allowed to stand.

D. RETURN FROM GASOLINE AND BUTANE OPERATIONS OF AFFILIATE.

Although the Circuit Court of Appeals held that the action of the Commission in crediting almost all of the affiliated Hope Construction and Refining Company's earnings to Hope was not "so arbitrary and unreasonable as to be invalid" (R. IV, 196), we think it important to point out, as the evidence showed (Rhodes, Ex. 101), that on the rate base calculations used by the Commission for the property of this affiliate all of its gasoline plants existing at December 31, 1938 will be fully depreciated by 1944. At the end of 1938 their book cost was $1,459,000 and the Commission deducted a calculated depreciation reserve to write

them down at that time to $428,000 (Ex. 63, R. III, 389). It claimed they were depreciating at the rate of $70,000 annually (*ibid*). Thus by 1944 they would appear in the Commission's rate base at $0. The complete artificiality of this bookkeeping theory and this result is demonstrated by the photographs of these gasoline plants taken in June, 1941 which appear in Exhibit 113. These photographs were not reproduced in the printed record by reason of the difficulty of reproduction, but they are well worth examining as visual evidence of the departure of the Commission's rate base theories from fact.

E. FEDERAL INCOME TAX.

In view of its reversal of the Commission's orders the Circuit Court of Appeals found it unnecessary to determine exactly what federal income tax the Commission should have allowed Hope in determining its operating expenses for the various years past and for the future (R. IV, 197). Nevertheless it is apparent that its judgment setting aside the Commission's orders (R. IV, 207) cannot be reversed unless the arbitrary action of the Commission on Hope's federal income taxes meets the approval of this Court.

(1) *Taxes allowed in retroactive findings.* The Commission found Hope's actual federal income taxes in 1939 were $191,521 and in 1940 $912,313 (Opinion, R. I, 61). In the Commission's Opinion it is reported that these actual taxes are "allowed" (R. I, 61) and in its "Findings as to Lawfulness of Past Rates" it is stated in Finding (17) that "the actual operations for 1939 and 1940 are the reasonable and proper bases for determining lawful rates in those years * * *" (R. I, 11). The fact is, however, that in retroactively fixing Hope's rates for 1939 and 1940 the Commission allowed Hope only $39,716 of federal income taxes in 1939 and none whatsoever in 1940 (R. I, 61, 12; R. IV, 41) although it fails to say so.

For 1941 and following years the Commission allowed Hope only $76,579 for federal income taxes although Hope in 1940 had, as we have seen, actually paid $912,313 (Opinion, R. I, 65).

The Commission's Opinion is wholly silent as to any justification for this action. It apparently proceeded on the wholly artificial concept that if Hope's rates had been as low as the Commission now says they should have been for the years 1939 to 1942, Hope would have had no income tax in 1940 and substantially none in 1939, 1941 and 1942. Of course under the rates actually collected by Hope in these years, elsewhere in the Commission's brief (pp. 116-117) admitted to be the legal rates during these years, Hope owed and paid very substantial income taxes. The Commission apparently assumed that Hope should have avoided the $912,313 federal income tax payment for 1940, for example, by changing its rates at the *beginning* of 1940 to the greatly reduced rates the Commission now proposes for 1940 on the basis of the operating results for the full year 1940, although neither Hope nor the Commission itself could possibly have known until well after the *end* of 1940 what those rates should be on any rate making theory (see page 139, *infra*).

The effect of this action by the Commission is disclosed in Appendix B, Table 1, of the Commission's brief. Shown there are Hope's federal income taxes as accrued in these years on the basis of its revenues under its filed rate schedules. These rate schedules were the same until July 15, 1942 after which they reflected the Commission's reduced interstate rates. The actual taxes so shown as compared with what the Commission allowed in fixing Hope's rates retroactively are as follows (R. I, 61, 12, 65):

Year		Federal Income Taxes: Actual	Federal Income Taxes: Allowed by the Commission
1939		$ 191,521*	$ 39,716
1940		912,313*	0
1941		1,750,000	76,579
1942		2,020,000	76,579
	Total	$4,873,834	$192,874

* Appendix B, Table 1, shows $225,000 and $1,000,000 for 1939 and 1940 which we have adjusted in accordance with the Commission's adjustments (Opinion, R. I, 60, 61). The 1941 and 1942 accruals may be subject to similar adjustments to reflect final actual payments.

It will be observed that the difference between Hope's actual federal income taxes in these years and the amount the Commission allowed for the purpose of its retroactive rate fixing order is over $4,500,000. Thus Hope has already paid to the federal government over $4,500,000 of the so-called "excess" revenues which the Commission claimed Hope had received in 1939, 1940 and since 1940 and which it labeled "unjust, unreasonable, excessive, and therefore unlawful" (R. I, 12-13).

(2) *Taxes allowed in fixing future rates.* The Commission took the position that under its reduced rates Hope would in the future have to pay only $76,579 of federal income taxes annually at an estimated 40% future federal income tax rate (Opinion, R. I, 64-65). This it termed a "saving" of $1,443,943 a year in the income tax Hope would pay if its former interstate gas rates were continued (Opinion, R. I, 64). As to this we note:

(a) On even the Commission's theories Hope's interstate rates were the lowest possible rates in pre-preparedness and pre-war years.[33] Because of increased prepared-

[33] In 1937 the Commission's rate would have been 32.7¢ and in 1938, 39.1¢, or an average of about 36¢ (from Commission

(*Continued on next page*)

ness and war demands for gas and consequent excessive consumption of Hope's own gas reserves, *which are given no value,* the Commission seeks to reduce Hope's rates to such an extent that the federal government is deprived of all or substantially all income taxes from the largest business Hope has had since World War I. This "tax-saving" is then passed out in the form of a still lower interstate rate for gas—for the benefit of individual consumers not responsible for the increased sales and better able to pay for their consumption of a limited natural resource than ever before.

(b) The Commission arbitrarily assumed that under its reduced interstate rates Hope would still be entitled under the Internal Revenue Code to its existing depletion deductions. The fact is, as shown in Hope's income tax reports which the Commission's Staff examined, that the amount of depletion for income tax purposes allowed Hope by the Internal Revenue Bureau is dependent upon the ultimate sales price of the gas produced (Internal Revenue Code, Secs. 23(m), 114(b)(3); Reg. 103, Sec. 19.23 (m)-1(f); *Consumers Natural Gas Co. v. Commissioner,* 78 F. (2d) 161 (C. C. A. 2d, 1935) cert. denied 296 U. S. 634; *Greensboro Gas Co. v. Commissioner,* 79 F. (2d) 701 (C. C. A. 3d, 1935), cert. denied 296 U. S. 639). With the Commission's reduction in Hope's interstate rates Hope's depletion allowance for tax purposes would decrease proportionately. This means that the Commission should have found, on its own theories, considering the matter to which we here call attention, that Hope under the Commission's own future rates would have to pay a great deal more federal income taxes than the Commission's allowance of

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(Continued from preceding page)

Staff's Exs. 67, 67A, 90, R. III, 224, 258, 349; Commission Counsel's Brief before the Commission, Appendix E; Commission Counsel's Reply Brief before the Commission, Appendix A; Opinion, R. I, 51-65). Hope's interstate rates actually averaged 36¢ for those years (Ex. 90, R. III, 353; Ex. 2, 2; Ex. 2B, 3).

$76,579. Worked out in figures, the result would be a decrease in the Commission's so-called "income tax savings" and a decrease in the amount of total rate reduction calculated by the Commission of about $200,000 each year.[34]

III. RATE OF RETURN.

The Commission fixed a rate of return of 6½%, based entirely upon current factors affecting this matter (Opinion, R. I, 65-67). The Circuit Court of Appeals sustained this finding under this Court's test in *Bluefield Water Works & Improvement Co. v. Public Service Commission*, 262 U. S. 679, 692 (R. IV, 198-199), although it noted that "in view of the low rate of return allowed"[35] there was

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[34] The Commission's reduced rates reduce Hope's gross revenues by at least $3,600,000. This would reduce its average earnings at the well mouth, after deduction of amounts attributable to transmission, by the same amount. Divided by the 74,000,000 M.c.f. total gas handled (Ex. 2-B, p. 3), this would be a reduction in the computed well mouth value of gas of about 5¢ per M.c.f. The gross income for income tax purposes from the 25,000,000 M.c.f. produced (Ex. 2-B, p. 10) would be reduced $1,250,000. The income tax depletion allowance based on 27½% of the gross income would in turn be reduced about $350,000. This would increase the income tax due at a 40% rate by $140,000. Under the Commission's method of computing its total rate reduction by adding "excess earnings" and "income tax savings," any such increase in Hope's operating expenses results in a decrease in the amount of rate reduction by 140% of such increase. Accordingly the final effect of this depletion adjustment would be a decrease of about $200,000 in the Commission's rate reduction.

[35] That the rate of return in this case is very low was proved not only as a matter of expert opinion (Ex. 19, R. I, 394), but in addition as a matter of fact by a statistical study of the market appraisal of the risks in various groups of utility enterprises made by Mr. Paul B. Coffman, Vice President of Standard & Poors Corporation. He took the aggregate average market prices for the bonds, preferred stocks and common stocks of all utilities of various classes for which the statistics were available and divided this into the annual earnings available for distribution to these securities for the 4-year period 1937 to 1940. His direct testimony is contained in Exhibit 27-A (R. I, 440) and the results of this are set forth in the following table (R. I, 441):

(*Continued on next page*)

a "consequent lack of margin to take care of error in the base" (R. IV, 172).

The test in the *Bluefield* case is that a public utility is "entitled to such rates as will permit it to earn a return *on the value of the property* which it employs for the convenience of the public" equal to certain standards there set forth (262 U. S., 692). This is not a measure of the return on a rate base which does not reflect, and is not designed to reflect, the value of a public utility's property.

The Commission here used a low present rate of return in combination with its original cost rate base. This is clearly inconsistent with the prudent investment method and is unreasonable on any theory.

No one recognized that the prudent investment rate base went hand in hand with a rate of return fixed as of the date of the investment more fully than did Mr. Justice Brandeis. In his classic exposition of the prudent investment theory in *State of Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission of Missouri, supra*, in which Mr. Justice Holmes concurred, he said (262 U. S. 304-306):

(*Continued from preceding page*)

Investors' Appraisal of Capital Risk in Various Divisions of the Utility Business.

	1937	1938	1939	1940	Four Year Average 1937-1940
Electric Utility Operating Companies	5.47%	5.50%	5.41%	5.43%	5.45%
Water Companies	5.52	5.39	5.66	5.23	5.45
Manufactured and Mixed Gas Company	6.17	6.61	6.61	6.88	6.57
Natural Gas Companies	7.91	7.79	7.53	7.97	7.80
Natural Gas Companies excluding Pacific Lighting Corporation	8.32	8.05	8.32	9.34	8.51

It will be observed that the investors appraise the risks of natural gas companies substantially higher than they do the risks of either electric companies or manufactured and mixed gas companies and at a rate substantially higher than the 6½% allowed by the Commission.

"That part of the rule of *Smyth v. Ames* which fixes the rate of return deemed fair, at the percentage customarily paid on similar investments at the time of the rate hearing, also exposes the investor and the public to danger of serious injustice. If the replacement-cost measure of value and the prevailing-rate measure of fairness of return should be applied, a company which raised, in 1920, for additions to plant, $1,000,000 on a 9 per cent. basis, by a stock issue, or by long-term bond issue, may find a decade later, that the value of the plant (disregarding depreciation) is only $600,000, and that the fair return on money then invested in such enterprise is only 6 per cent. Under the test of a compensatory rate, urged in reliance upon *Smyth v. Ames*, a prescribed rate would not be confiscatory, if it appeared that the utility could earn under it $36,000 a year; whereas $90,000 would be required to earn the capital charges. On the other hand, if a plant had been built in times of low costs, at $1,000,000 and the capital had been raised to the extent of $750,000 by an issue at par of 5 per cent. 30-year bonds and to the extent of $250,000 by stock at par, and ten years later the price level was 75 per cent. higher and the interest rates 8 per cent., it would be a fantastic result to hold that a rate was confiscatory, unless it yielded 8 per cent. on the then reproduction cost of $1,750,000. For that would yield an income of $140,000, which would give the bondholders $37,500; and to the holders of the $250,000 stock $102,500, a return of 41 per cent. per annum. Money required to establish in 1920 many necessary plants has cost the utility 10 per cent. on thirty-year bonds. These long-time securities, issued to raise needed capital, will in 1930 and thereafter continue to bear the extra high rates of interest, which it was necessary to offer in 1920 in order to secure the required capital. The prevailing rate for such investments may in 1930 be only 7 per cent.; or indeed 6 per cent.; as it was found to be in 1904, in *Stanislaus County v. San Joaquin & Kings River Canal & Irrigation Co.*, 192 U. S. 201; in 1909, in *Knoxville v. Knoxville Water Co.*, 212 U. S. 1; and in 1912, in *Cedar Rapids Gas Light Co. v. Cedar Rapids*, 223 U. S. 655,

670. A rule which limits the guaranteed rate of return on utility investments to that which may prevail at the time of the rate hearing, may fall far short of the capital charge then resting upon the company.

"In essence, there is no difference between the capital charge and operating expenses, depreciation, and taxes. Each is a part of the current cost of supplying the service; and each should be met from current income. When the capital charges are for interest on the floating debt paid at the current rate, this is readily seen. But it is no less true of a legal obligation to pay interest on long-term bonds, entered into years before the rate hearing and to continue for years thereafter; and it is true also of the economic obligation to pay dividends on stock, preferred or common. The necessary cost, and hence the capital charge, of the money embarked recently in utilities, and of that which may be invested in the near future, may be more, as it may be less, than the prevailing rate of return required to induce capital to enter upon like enterprises at the time of a rate hearing ten years hence. *To fix the return by the rate which happens to prevail at such future day, opens the door to great hardships. Where the financing has been proper, the cost to the utility of the capital, required to construct, equip and operate its plant, should measure the rate of return which the Constitution guarantees opportunity to earn.*

"The adoption of the amount prudently invested as the rate base and the amount of the capital charge as the measure of the rate of return would give definiteness to these two factors involved in rate controversies which are now shifting and treacherous, and which render the proceedings peculiarly burdensome and largely futile. Such measures offer a basis for decision which is certain and stable."

Again he said, page 307:

"In speculative enterprises the capital cost of money is always high; partly because the risks involved must be covered; partly because speculative enterprises appeal only to the relatively small number of investors who are unwilling to accept a low return on their capital."

In a note at the bottom of the same page he further said:

> "Of course, anyone who chances to have money to invest, when money rates are high, gets the advantage incident to investing in a favorable market. If he invests in utility bonds, the higher agreed return upon his capital would be provided for by a rule which measures fair return by capital charges, as suggested above. If he elects to invest in the stock, he would, under the rule suggested, have the opportunity of earning a return commensurate with the value of the capital at the time it was embarked as stock in the enterprise."

Mr. Justice Brandeis, of course, was talking about the cost of the outstanding capital securities of a public utility, having primarily in mind public utilities such as railroads which are largely financed by the sale of securities to the public. Where a corporation has no securities outstanding in the hands of the public, as in the case of Hope, it is not possible to determine from its records the cost of money to it. Mr. Justice Brandeis would be the first to recognize that in such a situation the cost of capital should be estimated precisely the same as he said original cost, where not shown by company records, should be estimated (see *supra*, pp. 36-37). In his opinion above quoted he recognized the obligation to pay interest on long term bonds at the contract rate over long periods of years in spite of a decline in interest rates and said that this was also true "of the economic obligation to pay dividends on stock, preferred or common" (262 U. S., 306).

Writing in 1923, he remembered that "money required to establish in 1920 many necessary plants has cost the utility 10 per cent. on thirty-year bonds." He intended to include that cost for bond money in the rate of return. Undoubtedly he contemplated that if common stock money at that time cost 12% or 15%, that also should be included. In other words he urged the rates of return necessary to

attract capital to the utility at the time it was attracted and invested in the property. He never urged the prudent investment rate base with a current rate of return.

As we have already seen practical application of this method of using a historical cost rate base undepreciated and a historical cost rate of return is made in California, *supra*, pages 68-73. There a higher return is used with the historical cost rate base than would be used by the same Commission on a fair value rate base. For example in the *Los Angeles Gas* case it was 7.7% on historical cost and 7% on fair value.

The Commission here determined a current rate of return to accompany its so-called "original cost" rate base. *It ignored entirely the historical cost of money that Justices Brandeis and Holmes recognized had to be reflected if an original or historical cost rate base were to be used.* Thus the Commission offers to the investor and to the public utility not a continuation of the rate of return they reasonably had a right to expect at the time the utility property was constructed, but whatever rate of return is current at the date on which rates are fixed. This is a departure from the prudent investment theory that robs it of all semblance of reasonableness.

Solely by way of rebuttal, after the Commission's Staff had testified to its rate base theories, Hope introduced testimony as to the rates of return that would have been necessary in various periods of Hope's existence (Brown, R. I, 443-464; Ex. 19, pp. 1-2; R. I, 395-396).

It is perhaps not important to review this testimony in any great detail since the Commission wholly ignored the historical cost of money. Briefly, it showed that in the "early development period" of Hope from 1898 to 1907, when it was a pioneer in a new and highly speculative industry, public financing was impossible and private investors would not have put money into such a property as that of Hope without prospective earnings of 15% to 20%; that in the period 1908 to 1926 when Hope had reached "a

certain stage of maturity and permanency" but when there was little public financing of natural gas companies, capital could not have been attracted to it at any time in the period for less than 12% and "some more than 12% in certain of those years." In fact the average earnings-price ratio of stocks of mining and smelting companies was 13% and of oil producing and refining companies was 14%. In the 1921 period the yield on Aaa bonds was 6% as against less than 3% today and on Baa bonds more than 8% as against 4½% today. In the third period beginning in 1927 when public financing of natural gas securities was practicable and until 1934 the capital requirements of Hope could not have been financed on the basis of less than 10%, and in the final period of lower money rates from 1935 to the present not at less than 8% (Brown, R. I, 446-464).

In Exhibit 136 the amount of plant existing on December 31, 1938 which was constructed in each of these four periods was applied against the minimum rates of return shown for those periods to get a weighted average historical rate of return. This weighted average on the basis of Hope's original cost was found to be 11.83% and on the basis of the Commission Staff's adjusted book cost to be 11.61%.

The Staff presented no study as to past or historical rates of return and the Commission ignored Hope's evidence.

The action of the Commission in taking an adjusted book cost rate base with a modern streamlined current rate of return is clearly arbitrary and unreasonable. It cannot be supported on the prudent investment theory or any other.

IV. VIEWED IN THEIR ENTIRETY THE RATES FIXED BY THE COMMISSION ARE TOO LOW BY ANY STANDARD.

(Com. Brief, 21-33; Cleve. Brief, 24-27)

Early in its brief the Commission claims that the rates prescribed by it, viewed in their entirety, "meet every test of reasonableness and fall far short of confiscation" (p. 25). In this section we shall first show that so viewed those rates are unreasonable on any standard and then consider the over-all matters to which the petitioners call attention.

A. THE COMMISSION'S PRESCRIBED RATES ARE TOO LOW BY ANY STANDARD.

Little need be said under this heading. All that the Commission allows in its future rates in this case for annual return, depreciation and depletion is (R. I, 12, 53):

For Return	$2,191,314
For Depreciation and Depletion	$1,460,037
Total	$3,651,351

For past rates it allowed even less (R. I, 12, 61).

This annual allowance for return is about 3.3% on the present value rate base of $66,000,000 claimed by Hope (Ex. 126, R. I, 481) and less than that return on the somewhat higher present value rate base found by the Ohio Commission as of June 30, 1937 (*supra*, pp. 8-9, 30). It is only slightly more than 4% of the over $50,000,000 true value in money of the interstate properties found for tax purposes by the State of West Virginia (*supra*, p. 30).

Moreover, it is equally inadequate if we test it by the prudent investment method of regulating rates as practiced in California where an undepreciated rate base is used and the annual depreciation allowance is based on the sinking fund method.

On the basis of the Commission's own findings as to "original cost" and using the California method of an undepreciated rate base the Commission's rate base for future rates would be as follows (R. I, 3-4):

Physical Properties and Operated Leaseholds	$51,957,416
Useful Unoperated Leaseholds	566,105
Working Capital	2,125,000
Net Capital Additions	1,392,021
Total	$56,040,542

On this undepreciated rate base the Commission's total allowance of $3,651,351 for annual return, depreciation and depletion is almost exactly 6½%. In other words by the California method and using the Commission's own findings it should have allowed Hope in rates at least as much *for return alone as it has actually allowed for both return and for depreciation and depletion.* Its own unadjusted figures thus show that upon its so-called prudent investment method it has included no allowance whatsoever for annual depreciation and depletion expense.

If in further pursuance of the California method we take an undepreciated rate base reflecting the true original cost of Hope's properties determined in accordance with the Natural Gas Act and consistently with the Commission's determination of operating expenses, that rate base for future rates would be as follows (R. I, 349, 364):

Original Cost[36]	$70,593,000
Working Capital	2,125,000
Net Capital Additions	1,392,000
Total	$74,110,000

On this undepreciated rate base the Commission's total annual allowance of $3,651,351 both for return and for

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[36] Hope's original cost of physical properties and leaseholds as of December 31, 1938 plus 1939 and 1940 net additions as found by the Commission (R. I, 36).

depreciation and depletion is not quite 5%. Thus the Commission's total allowance not only includes nothing for depreciation and depletion expense but is $1\frac{1}{2}\%$ shy of the rate of return the Commission allowed.

But this is not all. Had the Commission given any consideration whatever to a historical rate of return to accompany its "original cost" rate base it would have allowed a rate of return substantially higher than $6\frac{1}{2}\%$, in addition to depreciation expense on the sinking fund method of perhaps $1\frac{1}{2}\%$.

Thus it is clear that on either a present value or a prudent investment method of regulating rates, and even using the Commission's own findings, the rates fixed by its order are too low.

Moreover, in all the above computations no account is taken of the many respects in which the operating expenses of Hope were reduced and the amount available for return and depreciation consequently inflated. Thus, as heretofore shown, the Commission's allowance for depreciation and depletion expense omits all provision for depreciation and depletion of the well drilling and other costs that were not included in its rate base and for the net capital additions to 1942 that were included in its rate base. Hope's deep test well expenditures in 1940 are not included in expense. Federal income taxes as allowed are wholly inadequate. Net interstate revenues were arbitrarily increased by permitting Hope a wholly inadequate return on its West Virginia distribution plants. Hope's revenues were theoretically increased by appropriating to Hope practically all the earnings from the gasoline and butane operations of its affiliate, allowing substantially nothing for return on that property.

All of these matters and others only serve to accentuate the inadequacy of the rates fixed by the Commission.

B. THE COMMISSION'S RATES ARE TOO LOW ON THE BASIS OF THE PRICE ALLOWED FOR HOPE'S PRODUCED GAS.

There is another practical over-all test of the reasonableness of the Commission's order. The order in effect assumes that Hope can continue to sell abnormally large volumes of its own produced gas at prices reflecting costs over the last 45 years and which by any standard are unreasonably low.

The Commission's Staff's computation of Hope's net operating income from its interstate business at former rates was as follows (Ex. 133):

1937	$3,244,904
1938	1,186,435
1939	3,020,246
1940	5,576,982
3-year average—1937 to 1939	2,483,862
4-year average—1937 to 1940	3,257,142

It is obvious at a glance that the Commission could not have ordered a reduction of $3,600,000 in the interstate rates as it did on the basis of the experience of any year prior to 1940 or on either a 3 or a 4-year average. In fact such a reduction was greater than its own computation of Hope's income in any one of those years except 1940.

The Circuit Court of Appeals on this point said (R. IV, 197):

"*Selection of 1940 as test year.* The Commission selected 1940 without regard to the experience of the years immediately prior thereto, as the test year for determining expense of operation in fixing future rates. It is ordinarily unsafe thus to adopt the experience of a single year as a guide. *United Gas Public Service Co. v. Texas*, 303 U. S. 123, 145; *West Ohio Gas Co. v. Public Utilities Com'n*, 294 U. S. 79, 81. We do not think that under the peculiar circumstances of the case, however, this action of the Commission can be condemned as arbitrary or unreasonable. The increased demand for gas resulting from war conditions,

made the experience of 1940 a safer guide for the future than that of prior years. Hope makes much of the fact that the winter of that year was more than ordinarily severe and that the increased demand for gas resulted in a large percentage of sales representing gas from its own wells, which did not involve payment of the charge required by its contracts on gas purchased from others. The increased demand due to war conditions, however, must necessarily have the same effect, so far as this matter is concerned. The experience of 1940 was the only experience properly comparable. In further proceedings, the experience following 1940 can be added to the experience of that year to form a longer and more dependable test period."

Our point on this is not concerned with total demands or sales. Obviously during the war period the industrial demand will be sufficient to maintain the 1940 and even higher volumes so long as they can be supplied. But the increased volumes above a normal amount to a considerable extent have had to be taken from Hope's own depleted reserves and the incremental cost allowed for this additional volume in the Commission's rates is so low by any standard as to discredit the Commission's whole rate-fixing formula and its results. This is a matter of crucial practical importance that requires some explanation.

The gas business in the Appalachian area is wholly unlike that in either the southwest or California. There are no longer any large wells. Hope's supply comes from 16,000 small wells widely scattered over the state, many of them producing oil as well as gas. Of these it owns 3,300 wells and purchases the production of the remaining 12,600 (*supra*, p. 5).

Its method of operation for many years has been to rely on purchased gas to meet the minimum demands of its daily market and to produce its own gas to supply the difference between the minimum and the extremely fluctuating maximum daily demands (Tonkin, Ex. 4, R. I, 132-142). This method enables Hope to buy purchased gas on a

steady load basis at a lower price than it would otherwise be required to pay (*ibid.*, 142). Thus in July, 1939, for example, on several days it produced substantially nothing from its own wells; in January, 1940 it produced large quantities in varying daily amounts ranging up to 175,000 M.c.f. per day (Ex. 2, Chart, 16).

Hope therefore uses its own wells as a balance on its system precisely as an artificial gas company would use a storage gas holder. So important is the maintenance of Hope's own reserves that in recent years it has during off-peak periods stored gas in some of its depleted fields nearest its markets with gas from more distant sources (Tonkin, Tr. 5813-5815).

When increased industrial activity arising from the preparedness program began to manifest itself in late 1939 and the daily demands upon it increased Hope could not provide itself with additional supplies from the Appalachian field because they are not available (Tonkin, R. I, 504). Accordingly in 1940 it was compelled to withdraw from its own reserves designed to maintain a balance on its system more than 10 billion cubic feet above the amount it had withdrawn in 1939 or does withdraw in any normal year.

The effect of these extraordinary withdrawals in 1940 upon costs when costs are computed as the Commission did in this case is most startling. Cleveland computed this cost in its reply brief before the Commission in a table which we reproduce as Appendix D, page 183, *infra*. The table is based entirely on figures taken from the Staff's exhibits. It shows that Hope withdrew from its own gas reserves in 1939 16.5 billion cubic feet and in 1940 26.8 billion cubic feet (as estimated by the Staff), an increase of 10.3 billion feet. It then shows in detail the direct costs of this gas for the two years 1939 and 1940 to be respectively 11.88¢ and 8.73¢ per M.c.f.

In addition Cleveland worked out the incremental cost to Hope of producing 10.3 billion cubic feet in 1940 over

and above the normal 16.5 cubic billion feet it produced in 1939. This it found to be, using the Staff's methods which were followed by the Commission, 3.64¢ per M.c.f. (Appendix D, page 183 *infra*).

Thus the Commission's order in this case is based on the assumption that Hope can continue for the indefinite future to produce from its own declining gas reserves 10 billion cubic feet more than average withdrawals of peace time and supply it at the well mouth or can purchase similar quantities, at a direct cost of less than 4¢ per M.c.f. And this in face of the admitted fact that Hope cannot replace this gas at any figure approaching this cost. Even its steady load purchased gas has been costing it an average of 18¢ per M.c.f. (Ex. 78, R. III, 309).

The Commission made findings that should have warned it that a rate order based solely on this war time experience was arbitrary. It found the following facts, the last column only being added as a matter of computation (R. I, 12):

	1939	1940	Increase 1940 over 1939
Revenues from Interstate Sales..	$14,866,894	$19,296,755	$4,429,861
Operating Deductions	11,845,649	12,997,845	1,152,196
Net Operating Income from Interstate Sales	$ 3,021,245	$ 6,298,910	$3,277,665

In addition the Commission found the total interstate sales in 1939 to be 41,350,569 M.c.f. and in 1940 to be 53,604,243 M.c.f., an increase of 12,253,674 M.c.f. (R. I, 51).

Thus it found that an increase in sales of 12.2 billion cubic feet was achieved by an increase in operating expenses, which it refers to as "Operating Deductions," of only $1,150,000, or at a cost to Hope of only 9¢ per M.c.f. That is, at a time when the average market cost to Hope of purchased gas in the West Virginia fields was 18¢ per M.c.f., the Commission in effect found that Hope could supply at delivery points 12 billion cubic feet from its own reserves or otherwise at a cost of only 9¢ per M.c.f.

Thus the Commission's order in this case is based on the assumption that Hope can continue for the indefinite future to supply 12 billion cubic feet at delivery points at a cost of 9¢ per M.c.f. These low costs are achieved of course in part by the omission of the drilling costs of the wells and by other rate base and operating expense findings by the Commission to which reference has been made. In part it is due also to the low initial cost of gas discovered over the years for the present value of which no allowance is made.

The Commission's order fails to recognize that the Hope system cannot function without a well maintained gas reserve to meet peak demands. The order requires Hope to sell what is an essential part of its plant at a fraction of its replacement cost and at a fraction of its value either in the market or to Hope. No matter what theories may be advanced to justify such a result the result condemns itself. It is the arbitrary application to an extractive industry with special problems of a strait-jacket rate making theory which the Commission itself points out it developed in connection with its regulation of electric companies (Com. Brief, 68).

C. THE COMMISSION'S CLAIMS AS TO THE OVER-ALL REASONABLENESS OF ITS ORDER.

(Com. Brief, 25-33)

The Commission brief's first claim is that Hope's financial history justifies its order. Unless it is proper for the Commission now retroactively to regulate Hope's rates over the last 45 years Hope's financial history clearly shows that its recent rates have been entirely reasonable. Previously in this brief, *supra*, pages 11 to 13, we have set forth Hope's financial history since 1926—the first year of full operation of its present extended property. This shows that while its earnings from year to year have been most irregular, fluctuating as they do with both weather and industrial conditions, nevertheless on the average Hope has

earned for return, depreciation and depletion $4,150,000 or 7.7% of the average book cost of its fixed assets. From this record we know that those fixed assets are understated to the extent of $17,000,000.

Certainly there is nothing in that financial history that would justify the rates fixed by this Commission which are lower than the rates prevailing at any time during that 15-year period.

The Commission's next claim is that Hope's actual experience under the prescribed rates is such that it would have been justified in making a $1,091,790 larger reduction in rates than it made (Com. Brief, 28). This it seeks to prove by bringing into this record for the first time the annual reports Hope made to the Commission and calculations made therefrom and printed as its Appendix B. That at this date the record cannot properly be supplemented in this way has been decided by this Court (*West Ohio Gas Co. v. Public Utilities Commission of Ohio (No. 1)*, 294 U. S. 63). Aside from this, it should be pointed out that the Commission's order did not become effective until July 15, 1942 and that in consequence none of these annual reports can be used as experience under the new rates without substantial adjustments which the Commission's brief assumes to make.

However, if we take the Commission brief's own calculations in its Appendix B and make two simple adjustments, both of which are necessary in the interests of accuracy, the result is to show that on the Commission's own basis and theories the rate reduction ordered proved excessive by $600,000 in the year 1942.

Those two adjustments are:

1. The Commission brief's calculation (p. 141) starts with the revenues Hope would have received in 1942 if its former rates had remained in effect and with the Commission's findings of expenses for the year 1939, to which it adds the book increase in expenses between 1939 and 1942

to determine what the Commission would have found for 1942. But the Commission itself in fixing Hope's rates based its determinations exclusively upon the year 1940 without reference to prior years. (Opinion, R. I, 70). Accordingly the brief's calculation should likewise have been based upon the findings for 1940.

In Appendix E, page 185 below, we have set up the calculation exactly as the Commission brief shows it at page 141 except that 1940 is the starting point rather than 1939. All calculations are made by exactly the same method used by the Commission's brief.

2. In the second place, as the Commission brief recognizes in the footnote on page 141 but does not mention in its discussion, the net operating revenues computed in its Appendix B included the results of operation of the former Reserve Gas Company properties, merged into Hope on December 30, 1939, which by stipulation were excluded from consideration in this case (*supra*, page 19). A ready means of eliminating the revenues and expenses of these properties is furnished by the stipulation (Ex. 77) which sets forth the amounts of revenues, expenses and earnings to be excluded from 1940 data as attributable to these Reserve properties. It is a conservative assumption that the revenues and expenses of these properties would have been at least as much in 1942 as the stipulated 1940 amounts. Accordingly in Appendix E we have eliminated the Reserve property revenues and expenses in the exact amounts stipulated and in the exact manner that the parties did in eliminating them for 1940.

The net result of these two simple and necessary adjustments of the Commission brief's calculations as shown in column (5) of Appendix E is that the rate reduction which the Commission would have computed if it had based its rates upon 1942 operations rather than upon 1940 would have been $4,159,253 instead of the $4,757,452 (Com. Brief, 28) reduction in 1942 revenues actually resulting from its rate order. Thus instead of "earning $1,091,790 annually

in excess of a 6½% rate of return, if the 1942 level is taken as the criterion," as the Commission's brief claims (p. 28), *Hope is actually earning $600,000 less than the Commission would have allowed if it had used 1942 operations.*

So long as the experience of other years has been referred to it may also be observed that had the rates fixed by the Commission's order been in effect for the years 1937 to 1939 Hope's net operating income from interstate sales, using the Commission's determinations, would have been as follows (from Staff's Exs. 67, 67-A, 90, R. III, 224, 258, 349; Commission Counsel's Brief before the Commission, Appendix E; Commission Counsel's Reply Brief before the Commission, Appendix A; Opinion, R. I, 51-65):

1937	$ 708,653	
1938	(1,394,164)	loss
1939	333,502	
3-year average	($117,336)	loss

These three years include the year the complaint was filed, 1938, and one year's experience on each side. It is beyond controversy that the new rates would not have met any test of reasonableness in any one of these three years or even on the four year average including 1940.

It is next claimed that the rate base sought by Hope does not square with its operating experience since if Hope's claims as to rate base and operating expenses were allowed in full it would have only made a return of 3.27% for the 4-year period 1937-1940. This percentage is misstated, as shown in the footnote[37] below, but aside from this

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[37] The 3.27% is the amount Hope claimed it would earn in the future on the basis of average 1937-1940 revenue and expense experience, but adding to expenses the substantially increased Federal income taxes, wage payments and other increased future expenses not reflected during 1937-1940. Its actual experience during these years, based on a $66,000,000 present value rate base, Hope claimed was as follows (Ex. 126, R. I, 481):

(*Continued on next page*)

the issue here is not whether the rate base and operating expenses as claimed by Hope are 100% acceptable. The Commission did not base its order on these claims.

The history of rate proceedings as set forth in the Statement, *supra*, pages 6 to 9, indicates a very clear reason why Hope did not attempt to secure a higher rate in the years immediately preceding 1940. The rates of East Ohio, its principal customer, and also the rates of Peoples, its second largest customer, were involved in litigation in those respective states (*supra*, p. 8; *Peoples Natural Gas Co. v. Pennsylvania Public Utility Commission*, 14 A. (2d) 133 (Pa., 1940)). In view of the affiliation between Hope and these companies it was not possible actually to make effective a higher rate even though the return being earned by Hope was not adequate.

Finally it is claimed with apparent seriousness (Com. Brief, 30-33) that doubtful items of substantial amount were resolved by the Commission in Hope's favor. As we understand what is urged here, the Commission could reasonably and not arbitrarily have done the following:

(1) Reduced the $33,712,000 rate base it allowed for the future by $26,000,000—to $7,712,000;

(2) Decreased its allowances for Hope's annual operating expenses by over $600,000;

(3) Allowed instead of its 6½% rate of return only 5½% or preferably 5%.

We apply these suggestions. A 5% rate of return on a $7,712,000 rate base amounts to less than $386,000. $560,000 of the operating expenses which it is suggested

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(*Continued from preceding page*)

1937	3.98%
1938	1.18%
1939	3.36%
1940	6.98%

Even on its theories the Commission's Staff determined that in 1938 Hope was earning only 4.38% on a net book cost rate base of $31,465,000 (Ex. 90, R. III, 352).

the Commission might properly have eliminated consist of actual out-of-pocket payments for operating wages, property taxes and exploration costs (Opinion, R. I, 62) and for current administrative costs on current property construction (Opinion, R. I, 49-50). If these actual out-of-pocket expenditures of $560,000 are not allowed in operating expenses they must be paid out of the $386,000 return now suggested as reasonable. That is, of course, insufficient by $174,000.

Thus the "acoustics of such liberality" referred to in the Commission's brief (p. 33) are created from the argument that the Commission should reasonably have compelled Hope to operate at a $174,000 annual loss.

D. CLEVELAND'S CLAIM THAT NO CONSTITUTIONAL QUESTION IS PRESENTED.

Cleveland's brief does not urge that the over-all results reached by the Commission are reasonable, except to state that "Nothing arbitrary was done by the Commission" (p. 56) and to reiterate that all of the Commission's findings "had a rational basis and are supported by substantial evidence" (pp. 38, 39, 46, 52 and 55). Instead, Cleveland argues that Hope is not injured because its parent corporation also owns the stock of East Ohio and Peoples, Hope's largest customers although its petition for certiorari raises no such question.

This argument proceeds upon the premise that Hope, as a corporation, is not a "person" within the meaning of the Fifth Amendment and hence is not in itself entitled to constitutional protection. That this premise is erroneous we need not say. *Covington and Lexington Turnpike Road Company v. Sandford*, 164 U. S. 578, 592; *Kentucky Finance Corporation v. Paramount Auto Exchange Corporation*, 262 U. S. 544, 550; *Grosjean v. American Press Co.*, 297 U. S. 233, 244. Cleveland's argument likewise assumes that the Ohio and Pennsylvania rate regulatory authorities will fail to reflect the Commission's rate reduc-

ing order, if it should be held valid, or will permit East Ohio and Peoples sufficient additional allowances to offset the confiscation of Hope's properties. The history of the effective rate litigation in these states to which we have called attention, *supra*, pages 6 to 9, denies this premise. In fact, the result of this regulation has been to prevent Hope from receiving fully compensatory rates in the pre-war years, a fact now attempted to be used by the petitioners to deny the force of Hope's evidence.

Irrespective of all this, the Natural Gas Act requires that rates be "just and reasonable" without regard to any question of affiliation and the validity of the Commission's orders under the Act is here in question. As the Commission's brief points out (p. 15), "In judicial review under the Natural Gas Act, the statutory and constitutional standards coalesce." Hence, the question is presented whether the Commission's rates are "too low" under constitutional standards, even assuming every argument made by Cleveland were correct.

V. THE COMMISSION'S FINDINGS AS TO LAWFULNESS OF PAST RATES.

(Com. Brief, 110-123; Cleve. Brief, 60-77)

In 1939 Cleveland amended its original complaint against Hope and requested the Commission to determine that to the extent that Hope had charged East Ohio more than 30¢ per M.c.f., Hope had violated the Natural Gas Act ever since June 21, 1938, the effective date of the Natural Gas Act (R. II, 15). The Pennsylvania Public Utility Commission's complaint filed in 1939 included a request that the Commission determine that Hope had violated the Natural Gas Act since June 21, 1938 by reason of its charges to Peoples, Fayette and Manufacturers (R. II, 20, 22, 24). Neither Cleveland nor the Pennsylvania Commission introduced any evidence in support of these or other charges.

As a part of its final determinations the Commission made its "Findings as to the Lawfulness of Past Rates" (R. I, 8) and argued its right to make these findings in its Opinion (R. I, 67-69). These findings, where specific, are directed to Hope's past rates to East Ohio only. They ignore the request of the Pennsylvania Commission.

It is to be noted that these are not findings that Hope's existing interstate rates are unreasonable, which finding is required before the Commission can fix future rates and was made in its "Order Reducing Rates" (R. I, 1), but are separate findings that Hope's interstate rates to East Ohio on file *in the past* were unreasonable and "unlawful" and, further, are separate findings as to precisely what the "lawful" past interstate rates should have been.

The Commission's lack of statutory authority to make these retroactive rate determinations, their otherwise unreasonable and arbitrary character, and their reviewability have been analyzed and stated so clearly by Judge Parker (R. IV, 199-203) that discussion here is not really required. Furthermore, in *Public Utilities Commission of Ohio v. United Fuel Gas Co.*, 317 U. S. 456, this Court analyzed the rate provisions of the Ohio public utility law applicable in that proceeding which are substantially identical with the rate provisions of the Natural Gas Act. It said (317 U. S., 464):

> "If, after such hearing, the Commission finds that the rate or charge is unjust, unreasonable, or otherwise unlawful, it must 'fix and determine the just and reasonable rate, fare, charge, toll, rental or service *to be thereafter* rendered, charged, demanded, exacted or collected for the performance or rendition of the service, and order the same substituted therefor.' § 614-23 (italics added). The statute in terms thus gives the Commission power to prescribe such rates prospectively only. If, after notice and hearing, the Commission finds rates to be unlawful, it can then fix the just and reasonable rates 'to be thereafter' charged. The establishment of new rates must be

preceded by a finding that the old rates are unjust and unreasonable, and the new rates are prospective as of the date they are fixed. *There is no basis in the statute for concluding that the Commission's orders can be retroactive to the date when the Commission's inquiry into the rates was begun; on the contrary, the explicit language of the statute precludes such a construction."*

Nevertheless, in view of the extended arguments of the petitioners, we point out:

A. THE COMMISSION HAS NO AUTHORITY UNDER THE NATURAL GAS ACT TO MAKE THESE RETROACTIVE DETERMINATIONS.

1. Section 5(a) of the Natural Gas Act (15 U. S. C. 717d(a)) makes it crystal clear that the Commission's rate making authority is prospective only. As there stated, it may, after a hearing—

> "determine the just and reasonable rate, charge, classification, rule, regulation, practice or contract *to be thereafter observed and in force*, and shall fix the same by order:"

The Commission admitted the statute in its Opinion, stating (R. I, 68):

> "The Commission does not have the authority to fix rates for the past and to award reparations."

Despite this the Commission has in fact attempted "to fix rates for the past." It has determined that Hope's interstate rates were unlawful in designated amounts in 1939, 1940 and since (Finding (21), R. I, 12) and specifically as to Hope's rates to East Ohio it finds that they should have been 34¢ per M.c.f. in 1939 and 28.5¢ in 1940.[38] We note that during these years, and previously, Hope's actual filed rate to East Ohio was about 36.5¢ and that had the

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[38] Total allowed "compensation" shown in Finding (23) (R. I, 12) divided by quantities sold shown at page 40 of the Opinion (R. I, 51).

Commission applied its theories to 1937 and 1938 the East Ohio rates for those years on its own Staff's figures would have been 33¢ for 1937 and 39.5¢ for 1938,[39] or an average of almost 36.5¢.

What is intended to be done with these rates so fixed for the past is perfectly plain from the Commission's Opinion. They are to be reported to The Public Utilities Commission of Ohio in connection with its pending hearings as to the validity of certain 1939 and 1940 Cleveland rate ordinances specifying rates for East Ohio[40] (Opinion, R. I, 69) and the Ohio Commission is supposed to accept them as conclusive determinations of the rates East Ohio should have paid Hope in the past under the following pronouncement of the Commission in this case (Opinion, R. I, 69):

> "Since the enactment of the 1938 Natural Gas Act this Commission has had exclusive jurisdiction to determine the lawfulness of the interstate wholesale rates charged by Hope and other natural gas companies."[41]

Obviously the intended effect of the Commission's "Findings As to Lawfulness of Past Rates" in this case is "to

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[39] As shown *supra*, pages 104-105, the average rate for all of Hope's interstate sales which the Commission would have found on its own theories was 32.7¢ for 1937 and 39.1¢ for 1938. The Commission would have used the next even half cent, or 33¢ for 1937 and 39.5¢ for 1938, as the East Ohio rate. This is the way in which it derived its 34¢ East Ohio rate for 1939 and its 28.5¢ rate for 1940.

[40] As we pointed out in the Statement, *supra*, page 9, these ordinances are attempts by Cleveland to enforce beyond June 30, 1939 a rate which was held grossly confiscatory by the Ohio Commission in 1939 and by the Supreme Court of Ohio in 1940 (*Cleveland* case, *supra*, pp. 8-9). Cleveland's various claims (pp. 2, 63) that its consumers will be entitled to a $20 and a $13 per consumer refund if its views are sustained by this Court is merely a claim and nothing more.

[41] But see Section 22 of the Natural Gas Act, *infra*, pp. 133-134.

fix rates for the past" and through action of the Ohio Commission, which is to recognize the Power Commission's "exclusive jurisdiction" since 1938, "to award reparations," both of which the Commission frankly admits it has no authority to do. That Cleveland so construes its effect it states (Cleve. Brief, 63).

On this point the court below properly said (R. IV, 200):

> "* * * As the Commission itself says, it was not given authority to fix rates for the past or to award reparations on account of past rates. If it was not given the power to fix past rates, or award reparations based upon their unreasonableness, it certainly was given no power to do the same thing indirectly by making findings of fact as to past rates to be given effect in rate proceedings before state commissions. No intention on the part of Congress to vest any such unusual power in a commission ought to be indulged unless conferred in the plainest terms; and not only is it not plainly given here, but such power cannot be spelled out of the statutes on any theory of interpretation with which we are familiar."

2. That any such power would have to be found directly in the Act, and not by speculative implications from the general powers of the Commission under Sections 4(a), 5(a), 5(b), 14(a) and 17, which are the sections of the Act referred to by the Commission in its Opinion, is plain because Congress is well aware of the two separate kinds of rate making power—prospective and retroactive—and of the limitations that must be placed, as a practical matter, upon retroactive rate making powers if any such powers are granted. Congress's experience with these separate functions in connection with the Interstate Commerce Commission has been complete.

Originally the Interstate Commerce Commission was given no other power as to rates than the *quasi*-judicial power of investigating past rates on complaint of a shipper

and if it found them unreasonable to award reparation. The Hepburn Act of 1906 added to this *quasi*-judicial power the *quasi*-legislative power of fixing rates for the future if it found existing rates unreasonable (34 Stat. 589, 49 U. S. C. Sec. 15). But these two powers have always been regarded as separ te and distinct. In *Baer Brothers Mercantile Company v. Denver & Rio Grande Railroad Company*, 233 U. S. 479, Mr. Justice Lamar said (p. 486):

> "But awarding reparation for the past and fixing rates for the future involve the determination of matters essentially different. One is in its nature private and the other public. One is made by the Commission in its quasi-judicial capacity to measure past injuries sustained by a private shipper; the other, in its quasi-legislative capacity, to prevent future injury to the public."

See also *Arizona Grocery Co. v. Atchison, Topeka & Santa Fe Railway Co.*, 284 U. S. 370; *Interstate Commerce Commission v. Cincinnati, New Orleans and Texas Pacific Railway Company*, 167 U. S. 479.

Had Congress intended to vest *quasi*-judicial power in the Commission to determine the reasonableness and lawfulness of past rates and declare them for use by State commissions or others, it would have done so in express language as it has done in the case of the Interstate Commerce Commission. If the analogy of the Commerce Act were followed, such a finding would be provided for only upon complaint by the customer directly affected, made *within some short fixed period of limitations.* Such a statute would either have made that finding *prima facie* evidence in a court in which it was to be enforced or have authorized the Commission itself to make an order respecting it. Its effect would not have been left an uncertain matter for future debate. Here the Commission's brief seems most doubtful as to their effect (pp. 113-114) and certainly not in agreement with the Commission and Cleveland.

3. The rate regulatory scheme of the Natural Gas Act set forth in Sections 4 and 5 is entirely clear and complete. Rates must be filed with the Commission and until they are changed for the future by or with the approval of the Commission they "prevail." This is precisely what the Solicitor for the Commission said in explaining the Natural Gas Act to the Congressional Committee before its adoption.[42]

Under such provisions as Sections 4 and 5 of the Natural Gas Act it is perfectly well settled that the rate which is filed with the Commission is the only rate the utility can accept or its customers can lawfully pay, regardless of any claim that it is unreasonable, until changed prospectively by the Commission. *Texas and Pacific Railway Company v. Abilene Cotton Oil Company*, 204 U. S. 426; *Louisville & Nashville Railroad Company v. Maxwell*, 237 U. S. 94; *Dayton Coal and Iron Company v. Cincinnati, New Orleans and Texas Pacific Railway Company*, 239 U. S. 446 and other cases.

Congress obviously recognized that to confer upon the Commission jurisdiction to say that wholesale rates legally received and paid in the past in accordance with filed schedules were nevertheless unlawful and in violation of the Natural Gas Act would leave both the selling and purchasing gas companies in the greatest confusion. It is significant that the first draft of the Public Utility Act of 1935, which was the model for the subsequently enacted Natural Gas Act, contained a provision (Sec. 213) authorizing the issuance of reparation orders. This section was eliminated from the Bill by the Senate Committee on Interstate Commerce, together with another section. As to these sections the Committee said:

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[42] *Hearing before a Subcommittee of the Committee on Interstate and Foreign Commerce, House of Representatives, Seventy-Fourth Congress, Second Session, on H. R. 11662*, pages 28-29 (U. S. Government Printing Office, Washington, 1936).

"They are appropriate sections for a State utility law but the committee does not consider them applicable to one governing merely wholesale transactions." (*Report of the Senate Committee on Interstate Commerce on the Public Utility Act of 1935*, 74th Congress, 1st Session, Senate Report No. 621, page 20, see Appendix H hereto, page 150.)

Reviewing these considerations the court below properly observed (R. IV, 202):

"When rates were filed with the Commission pursuant to section 4(c) of the Act they became the only lawful rates which the utility could charge or accept. Cf. *L. & N. R. Co. v. Maxwell*, 237 U. S. 94. Until changed by the Commission under the power granted pursuant to section 5(a) they were binding alike upon the company and its customers; and, in the absence of a provision for award of reparation, there could be no occasion for a determination of their reasonableness except as reason for changing them in an order prescribing rates for the future."

4. Finally, we note that the Natural Gas Act itself states that the Commission shall have no jurisdiction to find anything "unlawful" and hence a violation of the Act, except as basis for exercising its prospective rate fixing power (Section 5(a), 15 U. S. C. 717d (a)). If the Commission wants to secure a determination as to the claimed unlawfulness of Hope's past rates to help the City of Cleveland or others it must proceed in the District Court where Hope will have its day in court. Section 22 of the Act provides:

"Sec. 22. The District Courts of the United States, the District Court of the United States for the District of Columbia, and the United States courts of any Territory or other place subject to the jurisdiction of the United States *shall have exclusive jurisdiction of violations of this Act* or the rules, regulations, and orders thereunder, and of all suits in equity and actions at law, brought to enforce any liability or duty created by, or to enjoin any violation of, this Act or any rule,

regulation, or order thereunder. Any criminal proceeding shall be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by, or to enjoin any violation of, this Act or any rule, regulation, or order thereunder may be brought in any such district or in the district wherein the defendant is an inhabitant, and process in such cases may be served wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 128 and 240 of the Judicial Code, as amended (U. S. C., title 28, secs. 225 and 347). No costs shall be assessed against the Commission in any judicial proceeding by or against the Commission under this Act."

Language could hardly be clearer. "Exclusive jurisdiction of violations of this Act" is vested in the District Courts and ergo is not vested in the Commission. If Hope has violated the Act by its former rate schedules as is claimed, jurisdiction to determine that matter is in the District Courts.

5. That *quasi*-legislative regulatory acts such as the Natural Gas Act do not confer the power to make any retroactive findings as to reasonableness of filed rates unless expressly so provided, is so clear that litigation has rarely been necessary. The theory adopted by the Commission in this case was once tried and promptly disposed of in *Great Western Portland Cement Co. v. Public Service Commission of Kansas*, 121 Kans. 531, 247 Pac. 881 (1926) where the court said (247 Pac. 883):

"The language of the present statute does not appear to us to give authority, expressly or by fair or even liberal interpretation, for the commission to make findings as to the reasonableness of a rate previously charged or as to what rate would at that time have been reasonable."

More specifically, the very construction of the Natural Gas Act adopted by the Commission in its Opinion had

already been denied by the Supreme Court of Ohio in the *Cleveland* case, *supra*, page 9. During the course of the hearings before the Ohio Commission as to the reasonableness of the Hope-East Ohio rate, Cleveland requested the Ohio Commission to stay its decision until the Federal Power Commission had retroactively adjudicated the "lawfulness" of the Hope-East Ohio rate. The Ohio Commission denied this stay and the Ohio Supreme Court affirmed this action as proper, saying (137 O. S., 253-254, 28 N. E. (2d), 613):

> "Any river rate the Federal Power Commission might designate would be of an entirely prospective nature and would consequently be of no benefit or controlling force in the present proceedings."

No other interpretation of the clear provisions of the Natural Gas Act is possible and the Circuit Court of Appeals properly so held.

The arguments made by the petitioners here that jurisdiction in the Commission to adjudge and in effect fix rates in the past is to be "implied" from various general provisions of the Natural Gas Act (Com. Brief, 114; Cleve. Brief, 63-65, 67-69) were most carefully considered by the court below which said (R. IV, 201):

> "In none of these sections is any power granted to make findings as to reasonableness of past rates 'as an aid to state regulation'; and in all of them taken together and construed in the light most favorable to the existence of the power, there is no indication of any intention on the part of Congress to grant such power. We cannot escape the conclusion that, if it had been the intent of Congress to grant unusual power of this sort, it would have said so plainly."

It likewise carefully considered the argument here again advanced (Com. Brief, 117; Cleve. Brief, 69-76) that rate payers "may be left without a forum to challenge the lawfulness of interstate wholesale gas rates prevailing be-

tween the date of the Act's passage and the effective date of a Commission rate-fixing order." The rate payers' forum is of course the Federal Power Commission and, as the court pointed out, that forum can act forthwith "in view of the provision of the statute for the entry of interim orders" (R. IV, 202).

Had that forum in this case acted forthwith upon the filing of Cleveland's complaint in 1938 it would have found, as the record in this case shows, that Hope's filed rate was not only reasonable but too low. It should have been even on the Commission's present rate-making theories over 39¢; it actually was 36¢ (*supra*, p. 104). There is, therefore, no question involved here of Hope filing an unreasonable rate and keeping it in effect "while defying the Federal Power Commission with its limited staff to determine and fix just and reasonable rates to be effective only after many years" (Cleve. Brief, 69). We also note that the rate Hope filed was found reasonable by the Ohio Commission in 1939 and by the Ohio Supreme Court in 1940 (*Cleveland* case, *supra*, pp. 8-9).

It is likewise significant that Cleveland's motion for an interim order reducing Hope's rates to East Ohio in the sum of $662,000 a year filed in September, 1940, was denied by the Commission, after full consideration, on December 20, 1940, although without prejudice to its final determination (R. II, 43-44). All of Hope's evidence in chief was then in. Had the Commission granted Cleveland's motion no one would ever have claimed the Commission had authority to fix retroactively the very much larger reductions for 1940, 1941 and 1942 it has now made. *Arizona Grocery Company v. Atchison, Topeka & Santa Fe Railway Co., supra*, page 131. Certainly the Commission on any reasonable standard of administrative conduct should not be permitted greater retroactive powers because it then found no basis for reducing Hope's filed East Ohio rate in any amount.

The record also shows that the time involved in this case, referred to in Cleveland's brief, was not caused by Hope. All of Hope's direct evidence was in by the summer of 1940 and the Commission then delayed the presentation of its evidence until the spring of 1941 (Tr. 1970, 2175-2176). Thus what the petitioners are really contending for is that the Commission can commence an investigation of rates which at that time are wholly reasonable on any theory, continue it for years, and finally determine that in some of these years the rate was "unlawful" and fix a hindsight rate for these years retroactively and so Cleveland states (Cleve. Brief, 75).

Had Congress intended any such power in the Commission it could easily and would obviously have said that the Commission's rate order would be effective from the date of the filing of a complaint or the initiation of an investigation. This it did not do. If Cleveland desires to have the Natural Gas Act amended to accomplish this result its forum is Congress and not this Court. Congress, we submit, would not legislate as the petitioners request this Court to legislate.

Nor is there anything in *Atlantic Coast Line Railroad v. Florida*, 295 U. S. 301 and *United States v. Morgan*, 307 U. S. 183, referred to by the petitioners (Com. Brief, 120-121; Cleve. Brief, 66-69), which supports the Commission's usurpation of retroactive rate-making power in this case. In both cases the federal regulatory agency had issued rate orders which were subsequently held invalid, solely by reason of procedural defects. In both cases the lower court, sitting as a court of equity, had control of the disposition of the difference between the old rates and the new rates thus invalidly prescribed. In both cases the regulatory agency subsequently and validly held the rates prescribed in the original order reasonable. All this Court held was that the court of equity below should dispose of the differences arising during the period *after* the first order in

accordance with the findings made by the regulatory agency. There was, and could be, no holding substaining the power of a regulatory agency to determine and fix "lawful" rates for any period before the original rate order was entered, as the Commission sought to do here.

The Commission's excursion beyond its statutory rate-making powers in the present case was properly curbed by the Circuit Court of Appeals.

B. THESE RETROACTIVE DETERMINATIONS ARE ARBITRARY AND INVALID.

Wholly apart from its lack of statutory authority to make retroactive rate determinations, those made by the Commission in this case are otherwise arbitrary and invalid. As to this we note:

1. They are based upon the Commission's same unlawful, arbitrary and unconstitutional bookkeeping theories of rate regulation and findings as to rate base, rate of return and operating expenses which it applied in its "Order Reducing Rates." Everything we have heretofore said thereon applies equally to the Commission's figures as to past rates.

2. They are based on the arbitrary assumption that Hope has paid less than $195,000 of federal income taxes in the years 1939, 1940, 1941 and 1942 whereas as we have seen Hope's actual taxes were $4,500,000 more than this (*supra*, p. 104).

3. In addition, the Commission entirely ignored the recommendation of its own counsel that it use the average period 1937-1940 in considering the reasonableness of past rates. Instead it made separate and individual determinations solely for the years 1939 and 1940, considering each year singly and separately in retrospect, just as if each year's business was a wholly separate operation, which could be successfully predicted on January 1 of that year.

In so doing the Commission adopted what Commissioner Manly in the course of oral argument almost characterized as "the rubber ball theory" of fixing rates when he said to Cleveland's attorney (Tr. 6896):

> "* * * you do not have a rate bouncing up and down from year to year, do you?"

The Commission's "rubber ball theory" of retroactive rate making prescribes a standard of conduct under the Natural Gas Act with which no natural-gas company can possibly comply. The results of a year's operation are not known accurately until the company's books are closed in the spring of the following year. Nevertheless on this theory, on January 1 of 1937 Hope should have foreseen that its 36¢ average rate would be too high for that year as its business finally worked out and reduced it to 32.7¢. On January 1, 1938 it should have foreseen that 32.7¢ would be too low for 1938 and raised it to 39.1¢, and so on indefinitely. The Commission holds that Hope should have done just this and that it violated the Natural Gas Act because it did not.

This utter impracticability the Circuit Court of Appeals necessarily recognized (R. IV, 203).

Petitioners argue (Com. Brief, 122; Cleve. Brief, 77) that *West Ohio Gas Co. v. Public Utilities Commission of Ohio*, 294 U. S. 63, 79, demonstrates this holding by the court below as its "final error." There the Ohio Commission was acting under the special ordinance appeal provisions of the Ohio statutes, under which it is expressly given power retroactively to substitute just and reasonable rates for the specific ordinance period if it finds the ordinance rate appealed from is invalid (Ohio General Code, §§ 614-44 *et seq.*; 294 U. S., 66, 80). The utility can, as it there did, suspend the ordinance rate and continue collection of its pre-existing higher rate by giving bond to refund any excess over the rate finally fixed or approved by the Ohio Commission (*ibid.*; see *Cleveland case, supra*, p. 9). Thus the utility

commits itself to abide by future retroactive rate orders, if valid, in exchange for the right to continue higher collections. It is of course entitled to have its refund liability determined on the facts actually prevailing during the ordinance period, as this Court held. But in absence of this commitment under these special ordinance appeal sections, it is not under the Ohio statutes subject to retroactive rate and refund orders, and is not expected to guess each year with absolute precision what the Ohio Commission would decide its rates should have been upon subsequent survey. *Public Utilities Commission of Ohio v. United Fuel Gas Co., supra,* pages 127-128.

This citation of the *West Ohio* case demonstrates that what Cleveland and the Commission attempted to do in the present case was to add to the Natural Gas Act the special features and to apply the particular considerations governing retroactive rate determination in the case of municipal rate ordinances in Ohio, with which Cleveland is familiar, but which in Ohio are added to the law by special statutory provision. The court below properly set aside this attempt.

CONCLUSION.

For the foregoing reasons it is respectfully submitted that the judgment below should be affirmed.

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October 12, 1943.

APPENDIX A.

The Legislative History of Section 6 of the Natural Gas Act.

Contents

THE LEGISLATIVE HISTORY OF SECTION 6 OF THE NATURAL GAS ACT.

Section 6 of the Natural Gas Act was copied directly from Section 208 of the Federal Power Act, which was enacted as part of the Public Utility Act of 1935. This Public Utility Act of 1935, as originally introduced (Senate Bill 1725 and House Bill 5423, 74th Congress, 1st Session), included a provision as to the rate base applicable both to Title II of the Act (the Federal Power Act) and Title III (regulating natural-gas companies), as follows:

> "Sec. 211. (a) The Commission shall have power to ascertain for the purposes of this title and title III the actual legitimate prudent cost of the property of every public utility, and every fact which in its judgment may or does have any bearing on the determination of such cost.
>
> "* * *
>
> "(c) In determining just and reasonable rates, the Commission shall fix such rate as will allow a fair return upon the actual legitimate prudent cost of the property used and useful for the service in question."

The Senate Committee on Interstate Commerce reported out a revised version of the Public Utility Act of 1935 (S. 2796), omitting Title III. The section quoted above was renumbered as Section 208 of the Federal Power Act and, as introduced, reported and passed by the Senate, provided as follows:

> "Ascertainment of Cost of Property; Rate Base
>
> "Sec. 208. (a) The Commission may investigate and ascertain the actual legitimate cost of the property of every public utility, the depreciation therein, and every fact which in its judgment has any bearing on the determination of such cost or depreciation.
>
> "(b) Every public utility upon request shall file with the Commission an inventory of all or any part of its property and a statement of the original cost thereof, and shall keep the Commission informed

regarding the cost of all additions, betterments, extensions, and new construction.

"(c) In determining just and reasonable rates, the Commission shall fix such rate as will afford the public utility an opportunity to earn a fair return on a rate base not in excess of the actual legitimate cost of the property used and useful for the service in question less the accrued depreciation therein." [43]

The report of the Senate Committee on Interstate Commerce on this bill pointed out that this section represented an attempt to induce the Supreme Court to uphold prudent investment as the rate base (see Statement A, page 147 below).

The House Committee on Interstate and Foreign Commerce substantially amended the Senate Bill (S. 2796) and changed Section 208 of the Federal Power Act to read as follows, in which form it was passed by the House and eventually enacted by Congress:

"Ascertainment of Cost of Property

"Sec. 208. (a) The Commission may investigate and ascertain the actual legitimate cost of the property of every public utility, the depreciation therein, and, when found necessary for ratemaking purposes, other facts which bear on the determination of such cost or depreciation, and the fair value of such property.

"(b) Every public utility upon request shall file with the Commission an inventory of all or any part of its property and a statement of the original cost thereof, and shall keep the Commission informed regarding the cost of all additions, betterments, extensions, and new construction." (49 Stat. 853, 16 U. S. C. Sec. 824g)

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[43] Quoted from the three printed copies of S. 2796 in the Senate as follows: S. 2796, introduced, read twice and referred to the Committee on Interstate Commerce May 7 (calendar day, May 9), 1935; S. 2796 (Report No. 621), Calendar No. 651, reported to the Senate, May 13 (calendar day, May 14), 1935; S. 2796, passed the Senate May 13 (calendar day, June 11), 1935.

The report of the House Committee pointed out that the provision in Section 208(c) of the Federal Power Act as passed by the Senate, quoted above, that cost be used as the rate base, was omitted from the revised bill reported to the House (see Statement B, p. 148 below). In explaining this change in Section 208 upon the floor of the House, Congressmen Lea and Cole, respectively chairman and a member of the sub-committee which redrafted the bill, pointed out that the change was necessary in order to make the section constitutional and that it would require the consideration of reproduction cost as well as original cost in the rate base (see Statements C and D, pages 149 and 150 below).

In the conference between the Senate and the House upon the various amendments, Section 208 of the Federal Power Act as passed by the House was not changed but was accepted by the Senate, and was enacted in the form quoted last above (see Statement E, page 152 below).

The Natural Gas Act itself was enacted in the 75th Congress, 1st Session, as H. R. 6586, originally introduced by Congressman Lea as H. R. 4008. Section 6 of the Natural Gas Act as initially introduced and as finally enacted was identical with Section 208 of the Federal Power Act as finally enacted except for the substitution of "natural-gas company" for "public utility." Section 14 of the Crosser Bill, H. R. 5711, which was introduced as an alternative to Mr. Lea's bill and considered by the House at the same time, was likewise identical with Section 208(a) of the Federal Power Act.

At the hearings on the Natural Gas Act before the House Committee on Interstate and Foreign Commerce on March 24, 1937, Mr. Harry R. Booth, counsel for the Illinois Commerce Commission, and Dr. Milo R. Maltbie, Chairman of the New York Public Service Commission, appeared as advocates of the Act. In the discussion between them and the members of the Committee it was apparent that everyone considered that under the Act the present fair value of

a natural-gas company's properties, determined upon consideration of original cost and reproduction cost, would be the rate base (see Statement F, p. 154 below). In the Committee report to the House and the debate upon the Natural Gas Act there was little discussion of the rate base but Congressman Lea, then Chairman of the House Committee, referred to the Committee's previous consideration of the provisions of Section 6 and stated that it had decided to cut out detailed provisions as to the rate base and "stay with the safe and unquestionably constitutional provision we have here" (see Statement G, page 158 below).

Section 6 of the Natural Gas Act was passed by the House and by the Senate without further comment.

Statement A

SENATE COMMITTEE REPORT ON THE PUBLIC UTILITY ACT OF 1935

"74th Congress 1st Session	SENATE	Report No. 621

"PUBLIC UTILITY ACT OF 1935

"May 13 (calendar day, May 14), 1935.—Ordered to be printed

"Mr. WHEELER, from the Committee on Interstate Commerce, submitted the following

REPORT

(To accompany S. 2796)

* * * * *

(Page 20):

"G. *Rates.*—Section 205 (b), transferred from section 202 (c) of the original bill, has been modified by prohibiting merely undue, instead of all, preferences or prejudices in rates. The provisions defining with particularity the power of the Commission to investigate single rates and to fix standards of service (former secs. 208 (b) and 210) and the section authorizing the issuance of reparation orders (former sec. 213) have been eliminated. They are appropriate sections for a State utility law, but the committee does not consider them applicable to one governing merely wholesale transactions. The provision requiring the fixing of rates upon the basis of the actual cost of the property devoted to the service in question (now sec. 208 (c)) has been modified so as to make clear that the rate base is to be no higher than the actual legitimate cost of the property. Furthermore, it is expressly provided that the accrued depreciation of property is to be deducted from the rate base, and the section (302 of S. 1725) requiring the sinking-fund method of depreciation accounting has been

eliminated. This practice is contrary to that of most of the States in the country and the committee is of the opinion that its introduction in a Federal statute would cause unnecessary confusion and hardship."

* * * * *

(Page 52):

"Section 208. Ascertainment of Cost of the Property

"Subsection (a) authorizes the Commission to investigate and ascertain the actual legitimate cost of the property of every public utility and the depreciation therein.

"Subsection (b) provides that every public utility upon request shall file with the Commission an inventory of its property and a statement of the original cost thereof and shall keep the Commission informed regarding the cost of all additions, betterments, extensions, and new construction.

"Subsection (c) provides that in determining just and reasonable rates the Commission shall fix such rate as will afford the utility an opportunity to earn a fair return upon a rate base not in excess of the actual legitimate cost of the property used and useful for the service in question, less the accrued depreciation therein.

"Rate regulation must eventually be based on prudent investment. Recent decisions of the Supreme Court, and the respect which the Court has always paid to the constitutional interpretations of the coordinate branches of the Government, afford grounds for hope that this rule which the committee considers essential to effective rate regulation will be sustained if the Congress should now definitely adopt it as a legislative policy. This would present the case to the Court in an entirely new light."

* * * * *

Statement B

HOUSE COMMITTEE REPORT ON THE PUBLIC UTILITY ACT OF 1935

"74th Congress 1st Session } HOUSE OF REPRESENTATIVES { Report No. 1318

"PUBLIC UTILITY ACT OF 1935

"June 24, 1935.—Committed to the Committee of the Whole House on the state of the Union and ordered to be printed

"Mr. RAYBURN, from the Committee on Interstate and Foreign Commerce, submitted the following

REPORT

(To accompany S. 2796)

* * * * *

(Page 30):

"Section 208. Ascertainment of Cost of Property

"The Commission is authorized under subsection (a) to ascertain the actual legitimate cost of the property of public utilities, the depreciation therein, and, when necessary for rate-making purposes, other facts which bear on the determination of such cost or depreciation and the fair value of such property. As an aid to such ascertainment, the public-utility companies may be required, under subsection (b), to file with the Commission an inventory of all or any part of their property, a statement of its original or historical cost and to keep the Commission advised as to the cost of additions, betterments, extensions, and new construction.

"In the Senate bill subsection (c), making the cost as ascertained under subsection (a) the base upon which the Commission shall fix rates, is omitted from the bill as reported."

* * * * *

Statement C

STATEMENT BY CONGRESSMAN LEA ON THE PUBLIC UTILITY ACT OF 1935 IN THE HOUSE OF REPRESENTATIVES, JUNE 28, 1935.

(Congressional Record, Vol. 79, Part 9, p. 10378, 74th Cong., 1st Sess.):

* * * * *

"RATES

"This bill also involves the question as to the rate base that should apply in governing the rates for public utilities. The bill contains the general rule that rates must be just and reasonable. The committee would like to have been able to provide a better standard of valuation as a rate-making base, but after considering the question fully we determined it would be a futile thing to do. After the recent decision of the Supreme Court in a Maryland telephone case it is practically a futile thing, in my judgment, for any legislative body to try to write a rate-making base.

"The Constitution has established a rate-making base that cannot be decreased or minimized; so when a legislative body attempts to write a rate-making base, we may add to the burden that may be placed upon the consumers of electricity, but we cannot subtract from their burden on account of anything that we may write in the way of a rate base. So without attempting to go any further, we have provided that rates shall be reasonable and just, and under the Supreme Court decision that means that the valuation must be based upon the current value of the property.

"Cost is an element of the rate base, but only an element. The cost of reproduction might be an element, but only an element. The one question is the current value of the property, and the Supreme Court will permit no deviation from this principle."

* * * * *

STATEMENT BY CONGRESSMAN COLE ON THE PUBLIC UTILITY ACT OF 1935 IN THE HOUSE OF REPRESENTATIVES, JUNE 28, 1935.

(Congressional Record, Vol. 79, Part 9, p. 10384, 74th Cong., 1st Sess.):

* * * * *

"* * * The Commission is empowered to determine the value of properties used in production and transmission of electric energy and to fix the rates and charges therefor. This is confined, naturally, to such part of the business as the Commission controls, leaving to the States that which is of intrastate character. The recent decision of the Supreme Court in the case of West and others against Chesapeake & Potomac Telephone Co. of Baltimore City, delivered June 3, 1935, has been most helpful in connection with framing this important section. There is nothing more important, in our judgment, when we come to deal with this entire subject than the setting up of necessary machinery whereby the Federal Government can appraise and value, for rate-making purposes, that part of the electric-utility business which is interstate in character and beyond the jurisdiction of the State regulatory agencies. Much of the delay and expense incident to rate cases conducted by the States has been directly attributable to the technicalities raised and the expense necessary for the State commission to properly cope with the matter.

"The bill was originally drawn on the theory that for the purpose of just and reasonable rates the Commission should determine the actual and prudent cost of the property less accrued depreciation thereon. Mr. Justice Roberts, in delivering the opinion of the Court in the Telephone case, *supra*, made it very clear that such a provision would be unconstitutional and it was therefore stricken out. In lieu thereof there is new language and while that may not be entirely clear, it was inconceivable to those of us serving on the subcommittee that any State or National commission establishing valuation of a public utility for rate purposes should do other than follow the very clear formula

sideration alone as to value such as legitimate cost or prudent cost, is sufficient; but all elements must be taken into account, such as reproduction value, actual cost, going value, proper depreciation allowance, so that in the end, after considering the aforegoing and such other elements of value as are essential, leave a figure upon which the rate established thereon will not be confiscatory. The dissenting opinion by Mr. Justice Stone on this case was also most helpful in clearing up the difficulties the commissions and courts have had in stating with definiteness that the theory of rate making outlined in Smith and Ames is still the rule, and if not, how it has been changed, by later decisions."

* * * * *

Statement E

CONFERENCE REPORT ON THE PUBLIC UTILITY ACT OF 1935

"74th Congress 1st Session } HOUSE OF REPRESENTATIVES { Report No. 1903

"PUBLIC UTILITY ACT OF 1935

"August 23 (calendar day, August 24), 1935.—Ordered to be printed.

"Mr. RAYBURN, from the committee on conference, submitted the following

CONFERENCE REPORT

(To accompany S. 2796)

"The committee of conference on the disagreeing votes of the two Houses on the amendment of the House to the bill (S. 2796) to provide for the control and elimination of public-utility holding companies operating, or marketing securities, in interstate and foreign commerce and through the mails, to regulate the transmission and sale of electric energy in interstate commerce, to amend the Federal Water Power Act, and for other purposes, having met, after full and free conference, have agreed to recommend and do recommend to their respective Houses as follows:

"That the Senate recede from its disagreement to the amendment of the House and agree to the same with an amendment as follows:

"In lieu of the matter proposed to be inserted by the House amendment insert the following:

"*That this act may be cited as the 'Public Utility Act of 1935.'*

* * * * *

(Page 53):

"*Ascertainment of Cost of Property*

"*SEC. 208. (a) The Commission may investigate and ascertain the actual legitimate cost of the property of*

every public utility, the depreciation therein, and, when found necessary for rate-making purposes, other facts which bear on the determination of such cost or depreciation, and the fair value of such property.

"(b) Every public utility upon request shall file with the Commission an inventory of all or any part of its property and a statement of the original cost thereof, and shall keep the Commission informed regarding the cost of all additions, betterments, extensions, and new construction."

* * * * *

Statement F

HEARINGS BEFORE THE HOUSE COMMITTEE ON THE NATURAL GAS ACT

"NATURAL GAS

HEARING

Before

THE COMMITTEE ON
INTERSTATE AND FOREIGN COMMERCE
HOUSE OF REPRESENTATIVES

Seventy-Fifth Congress

First Session

on

H. R. 4008

To Regulate the transportation and sale of natural gas in interstate commerce and for other purposes

MARCH 24 AND 25, 1937

Printed for the use of the
Committee on Interstate and Foreign Commerce

United States
Government Printing Office
Washington: 1937

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* * * * *

(Page 34):

"MR. MAPES. Both the Crosser and the Lea bills propose to give the Commission the power to fix a just and reasonable rate for gas.

"What do you consider a just and reasonable rate?

"MR. BOOTH. Well, if you will excuse me, Mr. Mapes, I am merely a lawyer, and the question as to what is a fair and reasonable rate is normally left to experts of a technical character.

"You mean what is the fair and reasonable return upon the investment, or do you mean what is a reasonable, fair, and reasonable wholesale rate?

"MR. MAPES. You are the attorney for the Illinois Public Utility Commission.

"MR. BOOTH. That is correct.

"MR. MAPES. The bills provide that the Commission shall have the authority to fix a just and reasonable rate.

"Does that mean a 5-percent return upon the investment, or a 10- or a 15-percent return?

"MR. BOOTH. Well, that all depends upon the individual circumstance. It will—the Commission will undoubtedly allow a fair return upon the fair value of the property of the pipeline company or a producing company devoted to public service."

* * * * *

(Page 36):

MR. COLE. Your amendment, as proposed to this bill, provides for a temporary rate which is pretty much of a guessing proposition, is it not?

"MR. BOOTH. Oh, no; not at all.

"MR. COLE. Why not?

"MR. BOOTH. As a matter of fact, it is much less of a guessing proposition than the determination of the final rate case as laid down by the decisions of the courts, because that amendment suggests that a temporary rate be fixed upon the original cost less accrued depreciation of the physical property of said company used and usable in the gas service plus a reasonable amount for working capital, * * *.

"* * *

"* * * the fixing of the tentative rate base, which is to be determined on the basis of the original cost, eliminates the guesswork that is usually involved in determination of fair value based upon reproduction cost basis and that is a determination arrived at from the testimony and estimates of engineers. Our courts have held that in the determination of fair value, original cost and reproduction cost is to be considered in arriving at the fair value of the

property of the utility company. The New York Court of Appeals has recently sustained the temporary rate provision just referred to."

* * * * *

(Page 37):

"Mr. Booth. I am suggesting this, that because of the time and the delay which usually occur in determination of a final rate that the Commission arrive at a tentative or temporary rate base by taking one of the factors which the courts have said must be considered, in determining fair value, namely, the original cost, and since the original cost can be determined and should be determined with a high degree of accuracy, and since it will give the utility company or the company that is being regulated, presumably, a return upon the money that actually has been expended in the construction of its property and facilities, there does not seem to me anything highly unfair about that.

"Now, it is true that when the Commission determines the final rate, it will then give consideration both to the original cost, less depreciation, and the reproduction cost, less depreciation, and arrive at the final rate base.

"Mr. Cole. Yes; and those elements which you say the Commission would consider in establishing a final rate, as I understand the law, are required to be taken into consideration.

"Mr. Booth. That is right.

"Mr. Cole. You cannot establish a rate solely on original cost."

* * * * *

(Pages 114-115):

"The Chairman. In brief, how do you fix your temporary rate?

"Mr. Maltbie. The temporary rate is fixed upon the basis, according to the law, of the original cost of the physical properties, less depreciation.

"Now, we make an investigation. In some cases the books of the company show the original cost of the property and we have an order out now which will require all of the utilities outside of the railroads in the State of New

York to produce an inventory and show the original cost of their property before the end of this year.

"So, if the book shows we get original cost from the books. If the books do not show we are allowed to estimate the original cost.

"Also the depreciation, if the books show accrued depreciation, we take that from the books. If we do not think that they do, we can quickly make an estimate or fix the minimum amount that we will deduct and deduct that from the original cost, getting the original cost less depreciation, taking all of the physical property, material, supplies, as well as plant. Then, an analysis of the operating expenses show what the revenue should be and we can fix a rate of return on it and do fix it. So far there has not been a temporary rate fixed on that basis reversed in the State of New York; not one.

"THE CHAIRMAN. In effect you give consideration to every fact that you do in fixing the final rate, but you act hurriedly and save yourselves as to the constitutional question in the final rate where you pay the company any deficiency that may be found due.

"MR. MALTBIE. No, Mr. Chairman; I have not included reproduction cost less depreciation.

"Now, according to the law of the land original cost and reproduction cost less depreciation must be taken off of each one and must be considered. There are a number of other things that might be considered before fixing a final rate, but in a temporary rate we do not need to give any consideration to reproduction cost less depreciation; none at all."

* * * * *

Note: The persons participating in the foregoing discussion were:

Mr. Mapes, Congressman Carl E. Mapes, member of the Committee.

Mr. Booth, Harry R. Booth, Acting Counsel for the Illinois Commerce Commission.

Mr. Cole, Congressman William P. Cole, Jr., member of the Committee.

Mr. Maltbie, Milo R. Maltbie, Chairman, Public Service Commission of New York.

The Chairman of the Committee, Congressman Clarence F. Lea.

Statement G

STATEMENT BY CONGRESSMAN LEA ON H. R. 6586 IN THE HOUSE OF REPRESENTATIVES, APRIL 28, 1937.

In the course of the reading of the Natural Gas Act (H. R. 6586, Seventy-Fifth Congress, 1st Session), Congressman Poage offered an amendment to Section 6 requiring the Commission in valuing a natural-gas company's properties for rate case purposes to exclude the value of the properties used for industrial gas, and further providing that it should be conclusively presumed that such property was a percentage of the total property equal to the ratio of the industrial gas to all gas sold by the company. Congressman Lea, Chairman of the House Committee on Interstate and Foreign Commerce, opposing the amendment, said (Congressional Record, Vol. 81, Part 6, p. 6729):

"* * * I think the standard proposed here to cover the action of the committee, in the exercise of its powers, is not authorized by the Constitution.

"* * * I believe under the definition of fair value as defined by the Supreme Court, the amendment would make it the duty of the Commission to do a thing that is not justified by the interpretation of the term 'fair value.' We spent a great deal of time on this section, and we had before us another section, such as the gentleman has here suggested, going into more detail, but, in the meantime, a Supreme Court decision came out that made it very clear we should cut out such details and stay with the safe and unquestionably constitutional provision we have here."

APPENDIX B.

Original Cost is a Matter of Actual Expenditures, Not of Bookkeeping, and Where Not Shown by Records is to be Estimated.

Treatises.

Spurr, Henry C. *Guiding Principles of Public Service Regulation,* Volume I, pp. 290-299.

"The term 'original cost' has been defined as the sum of money expended for the property in use at the time of the valuation for the benefit of the public. It has been said to be not what the original property cost, but rather what the present property cost."

* * *

"Original cost of construction does not necessarily mean book cost. * * * It means actual bona fide cash cost of existing property.[46] The cost shown by the books sometimes referred to as book value may not fairly represent the amount of the investment because the capital account may be overcharged or the operating account undercharged.[47] In the early days there was no uniform system of accounting and, whereas frequently items were unfairly added to the assets column, to balance the liabilities, on the other hand, items which should properly have been classified as fixed capital expenditures were frequently included in the operating expenses.[48]

* * *

"If for any reason the actual cost cannot be obtained from the books or records, it may be estimated. This estimated cost has been called historical cost, probably because the estimate is based upon a history of prices prevailing at the date of the installation.

"[46] *Re Mid-Crosstown R. Co.* (1914) 5 P. S. C. R. (1st Dist N. Y.) 22;
Re Indianapolis Water Co. (Ind.) P. U. R. 1917 E, 556."

"[47] *Re Madison City Water Works* (1909) 3 Wis. R. C. R. 299.

"[48] *Re New York State Railways* (N. Y.) P. U. R. 1921 C, 496; *Mairies v. Flatbush Gas Co.* (N. Y.) P. U. R. 1920E, 930."

This would seem to be a proper use of the term, but it has not always been employed in this sense. It has sometimes been considered as synonymous with original cost.

• • •

"The method of estimating original cost is the same as that employed in determining reproduction cost except that in the case of original cost there may be and usually are applied several average unit costs varying in amounts according to the period during which the particular portions of the plant were constructed, whereas, for reproduction cost, there is but one average unit cost applicable to all units of the same kind.[59] In estimating original cost, current prices may be obtained from information gathered from the company's original vouchers and contracts, manufacturers' quotations as of the time when the installations were made, catalogues, market reports, and prices current for similar material in other locations. Labor unit costs may be computed from information gathered from the company's pay roll and rates of pay in effect in other states during the period.[60]"

"Out of the Mail Bag," *Public Utilities Fortnightly*, Vol. 17, No. 4, Feb. 13, 1936, p. 250.

"Standardized definitions of the various kinds of 'cost' should simplify regulatory proceedings. The following suggestions are tendered for consideration:

" 'Original cost' to mean the total outlay of actual dollar costs (or equivalent) of the now existing property, from the date of the initial expenditure to the date of inquiry. This information to be actually obtained from the vouchers, invoices, etc., for the entire period, and applying only to those properties where there are continuous, reliable, accurate, detailed records of construction costs throughout the entire history and bearing no relation to changes in ownership.

"[59] *Public Service Commission v. Nevada-California Power Co.* (1913) 3 Ann. Rep. Nev. P. S. C. 261, 276.

"[60] *Re Flint* (Mich.) P. U. R. 1922A, 385, 393."

"'Historical cost' to mean an inventory of the physical property as it actually exists at the date of inquiry, to which is applied the correctly weighted average prices that prevailed during the construction period. This plan may be used where the records of original capital expenditures are not obtainable or where they are so generally inadequate as to be unreliable. Changes in ownership to be given no consideration.

"'Original-historical cost' to mean 'original cost' as first defined above, in so far as dependable construction records are available for a substantial period of time, and for that time in which there is a partial lapse of such records, a list of the now existing property which was constructed during such lapse periods shall be made and correctly weighted average prices of labor and material, etc., effective during such period applied thereto. This also ignores changes in ownership."

Whitten, Robert H. *Valuation of Public Service Corporations. Legal and Economic Phases of Valuation for Rate Making and Public Purchase. Supplement.* (New York: The Banks Law Publishing Co., 1914.) pp. 834-836.

"The term 'actual cost' may possibly be taken in three senses; (1) book cost; (2) the first cost of the original units; (3) the first cost of the identical units now in use. The confusion has arisen from identification of actual cost with book cost or first cost of original units, or both. Properly speaking, actual cost is the first cost of the identical units now in use. In the past both the terms 'actual cost' and 'original cost' have been used, the term 'original cost' being most frequently employed. The term 'actual cost' should be substituted, as the term 'original cost' appears to mean the first cost of the original units.

"Book cost would be the same as actual cost, *i.e.*, the first cost of the identical units now in use, assuming that approval accounting principles had been strictly applied from the initiation of the enterprise. Correct accounting principles are, however, of comparatively recent acceptance and application. Book costs as actu-

ally developed often include discount on securities issued, exorbitant profits to promoters, cost of replacing wornout or superseded property, dividends paid out of capital and money sunk in unsuccessful experiments. On the other hand, book cost may exclude various actual costs, such as improvements and betterments constructed out of earnings and overhead construction charges included in operating expenses.

* * *

"Assuming that existing accounts and records may be only partially relied upon, an estimate of actual cost can be ascertained by much the same methods as and with greater accuracy than an estimate of reproduction cost. The first essential in either case is a complete inventory of property units in use. A second requirement in both cases is the determination of the approximate time at which each such unit was installed. This information is essential under the reproduction method in order to determine the age and accrued depreciation of each unit or class of units. It is essential under the actual cost method in order that unit costs varying with the period of purchase may be applied. Records are available showing for any period the prevailing prices of labor and materials entering into construction costs. From such records, supplemented in many cases by fragmentary data obtainable from the books of the company, it is possible to apply unit costs."

Willard J. Graham and Wilber G. Katz, *Accounting in Law Practice* (Callaghan and Company, Chicago, 1938), p. 228.

"Literally, original cost is the total amount (in dollars) that has been expended by the utility at one time or another in the construction or acquisition of the properties which are at the time of the inquiry included in the rate base as being 'used and useful' in the operation of the business. This amount is readily determinable from the books of account, if they have been properly kept since the founding of the business. In the absence of proper records it is often necessary to substitute an estimate of what the cost of the prop-

erties should have been at the date of their acquisition."

Bemis, Edward W., "Original Cost as the Chief Basis for Fair Value." 1 *Utilities Magazine*, No. 3 (1915) p. 36:

"By original cost in the case of physical assets is meant the actual cost of the property now in use."

Erickson, Halford, "Relation Between the Valuation and the Rate of Return Thereon." *N. A. R. C. Proceedings of 25 Annual Convention*, 1913, p. 435.

"The original cost of the plant and of its business may be defined as the amount of money judiciously expended on the property used and useful in the service and on the development of the business."

Smith, Nelson Lee. *The Fair Rate of Return in Public Utility Regulation.* (Boston and New York: Houghton Mifflin Company, 1932), p. 22.

"The original cost method has been styled 'original cost to date,' 'historical cost,' and 'investment' or 'prudent investment' cost. Although these various terms are not always uniform in meaning, the original cost appraisal yields, not the cumulative costs of superseded as well as existing properties, but, rather, the sums actually paid for the units now in service when those items of property were acquired. But before values are assigned according to either one of these price methods, a physical count, or inventory, of the property must be made."

Hartman, Harleigh H., *Fair Value* (The Meaning and Application of the Term "Fair Valuation" as used by Utility Commissions) (Houghton Mifflin Company, The Riverside Press, Cambridge, 1920) p. 109.

"The campaign to discredit original cost failed because the propaganda could not obscure the fact that such valuation is not dependent upon a complete record, but may be estimated just as reproduction cost is calculated, and with as great or even greater accuracy. Original cost can be figured upon the same inventory as reproduction cost by merely substituting prices of

material and labor, which were current at the time the items inventoried were put into the plant, for the present or normal price used in the reproduction cost appraisal. The original prices may be secured in part from the records of the firm and in part from the market quotations of the period."

United States Supreme Court.

City of Knoxville v. Knoxville Water Company, 212 U. S. 1.

"When, therefore, a public regulation of its [a utility's] prices comes under question the true value of the property then employed for the purpose of earning a return cannot be enhanced by a consideration of the errors in management which have been committed in the past." (p. 14.)

Doyle v. Mitchell Brothers Company, 247 U. S. 179.

"Nor is the result altered by the mere fact that the increment of value had not been entered upon plaintiff's books of account. Such books are no more than evidential, being neither indispensable nor conclusive. The decision must rest upon the actual facts, which in the present case are not in dispute." (p. 187.)

Lincoln Gas & Electric Light Company v. City of Lincoln, 250 U. S. 256.

"Again, we question the propriety of the master's treatment of 'going value,' which he seems to have estimated at less than otherwise he would have placed it upon the theory that the company's business had been developed, at the expense of the public, in the expenditure of past earnings exceeding a fair return upon the capital invested, and this without any finding, or any clear evidence to which our attention has been called, that past earnings were excessive." (p. 267.)

State of Missouri ex rel. Southwestern Bell Telephone Company v. Public Service Commission of Missouri, 262 U. S. 276.

(See quotation at pp. 36-37 above.)

Board of Public Utility Commissioners v. New York Telephone Company, 271 U. S. 23.

(See quotation at pp. 50-51 above.)

Columbus Gas & Fuel Co. v. Public Utilities Commission of Ohio, 292 U. S. 398.

"Leases bought with income, proceeds of the sale of gas, and *thus paid for in the last analysis through the contributions of consumers*, ought not in fairness to be capitalized *until* present or imminent need for use as sources of supply *shall have brought them into the base* upon which profits must be earned." (p. 407)

Federal.

Garden City v. Garden City Telephone, Light & Mfg. Co., 236 Fed. 693, P. U. R. 1917B, 779 (C. C. A. 8th, 1916).

The Court rejected the city's claim that the utility was not entitled to a full return upon the present value of its property because it had been paid for from earnings, saying:

"No judicial authorities are cited on this point. In the first place there is no evidence that the company ever charged excessive rates until about the commencement of the controversy out of which this litigation arose; but, if it did so, the various parties from whom they were extorted had a cause of action against the company to recover the excessive rates until the statute of limitations had run. Presumptively they were not the identical persons who are now the consumers from the appellee. It is the practice of courts to try cases one at a time; and if the appellee has put money into the development of the plant, the court in this case could not stop to inquire just how it acquired the title to the money. Such a system would involve an investigation into the wholly collateral matter of the entire past life of litigants and the manner in which they acquired the money invested in a private enterprise." (p. 697.)

Brooklyn Borough Gas Co. v. Prendergast, 16 F. (2d) 615, P. U. R. 1927A, 200 (D. C., E. D. N. Y., 1926).

"Book cost in a confiscation rate case is not decisive of value, and quite properly, for it indicates the price of acquisition of property, which is one thing, and not present value, which is quite another thing." (p. 625.)

City of Minneapolis v. Rand, 285 Fed. 818, 822-824 (C. C. A. 8th, 1923).

Monroe Gaslight & Fuel Co. v. Michigan Public Utilities Commission, 292 Fed. 139, 147, P. U. R. 1923E, 661 (D. C., E. D. Mich., 1923).

Indiana Bell Telephone Co. v. Public Service Commission of Indiana, 300 Fed. 190, 197, P. U. R. 1925A, 363 (D. C., D. Ind., 1924).

Wichita Gas Co. v. Public Service Commission of State of Kansas, 3 F. Supp. 722, 726 (D. C., D. Kans., 1930), modified and affirmed, 290 U. S. 561.

Illinois Bell Telephone Co. v. Moynihan, 38 F. (2d) 77, 86, P. U. R. 1930B, 148 (D. C., N. D., Ill., 1930), reversed, *Smith v. Illinois Bell Telephone Company*, 282 U. S. 133.

Pacific Gas & Electric Co. v. Railroad Commission of California, 26 F. Supp. 507, 514, 26 P. U. R. (N. S.) 1 (D. C., N. D. Calif., 1938).

Interstate Commerce Commission.

Texas Midland Railroad, 75 I. C. C. 1 (1918).

In determining the $2,892,361 "original cost" or "investment" as evidence of fair value, the Commission included substantial sums which had originally been charged to expense or to income. The Commission explained the method followed by its staff as follows:

"When the bureau realized that it was impossible to obtain accurate information from the books of the com-

pany concerning original cost to date, it reconstructed the accounts upon what it believed to be a proper basis. To accomplish this it was necessary to examine every voucher which had been issued by the carrier for the payment of money since 1893, the date when its operations began." (p. 10.)

"It became evident that the investment account of this carrier had not been correctly kept and an attempt was made to restate that account in accordance with our accounting rules now in force. For this purpose the entire books of the Texas Midland Railroad were in effect rewritten, every voucher being examined and reassigned as far as possible." (p. 98.)

Elgin, Joliet & Eastern Railway Company, 84 I. C. C. 587, 592 (1924).

New York, Philadelphia and Norfolk Railroad Company, 97 I. C. C. 273 (1925).

"The question to be determined is whether the voluntary act of the carrier in charging only a portion of the cost of road and equipment to its investment account estops it from thereafter claiming as investment the additional cost not charged out properly in the first instance. Under the mandate of the statute we are required to find the value of the property of the carrier. The investment account, when properly stated, constitutes evidence of value to which consideration must be given. In this case the investment in property being devoted to carrier purposes on valuation date is incompletely stated in that costs incurred therefor were entered as charges to income. If our present system of accounting had been in force when the entries were made the investment account would have included the amount here claimed as proper.

"In previous cases instances have been found where the investment account has been incorrectly kept, capital expenditures being recorded in operating expenses or as charges to income. In order to obtain an accurate statement of investment it has been necessary in such instances to reconstruct the accounts. Here the carrier has presented evidence of costs that have not been in-

cluded in our restated investment figure, although the property was found in ownership and use on date of valuation, was inventoried and is included in our estimates of cost of reproduction new and less depreciation. The evidence is persuasive that the investment figure should be increased by the amount of $733,846.13 and our tentative report will be revised accordingly. * * *" (p. 279.)

Chicago, Burlington and Quincy Railroad Company, 134 I. C. C. 1, 19 (1927).

Hamilton Belt Railway Company, 149 I. C. C. 126 (1928).

Depreciation Charges of Telephone and Steam Railroad Companies, 177 I. C. C. 351, 407 (1931).

California.

Re Los Angeles Gas & Electric Corporation, P. U. R. 1917 F, 717 (Calif. R. R. Comm., 1917).

"In arriving at the sum upon which to calculate the fair return to the company, I have used an estimate of original cost of the entire plant which is now found in use, and have not depreciated this cost. In other words, I have concluded that the just and reasonable thing to do in this proceeding is to allow the company a return upon its actual investment in this property. This includes money invested regardless of the source from which such money came. For instance, no deduction has been made because a part of the depreciation reserve has been invested in plant, nor has any deduction been made because a part of the earnings of the company in times past have been invested in plant.

"Reinvested earnings are legally as much a part of the stockholders' equity in the property as is the property represented by a direct investment by the stockholders." (pp. 722-723)

Re City of Los Angeles, P. U. R. 1916F, 593, 601 (Calif. R. R. Comm., 1916).

Re Napa Valley Electric Company, P. U. R. 1925A, 724, 730 (Calif. R. R. Comm., 1924).

Colorado.

Re Mountain States Telephone & Telegraph Company, P. U. R. 1917B, 198 (Colo. P. U. C., 1917).

"The experience of this Commission discloses that book values of public utilities are of very little assistance in obtaining fair value for rate-making purposes. The methods adopted by the various public utilities in building book values are not uniform, and the accounting methods in the past have been far from uniform, as no regulatory boards were in existence to prescribe the methods of accounting, from which book values could be ascertained. Some public utilities build up enormous book values based on many erroneous assumptions; other utilities—of which class the present utility is one—have not taken into consideration proper methods in building up an adequate book value, as has been disclosed from the testimony in this case." (pp. 286-287)

District of Columbia.

Re Washington Gas-Light Company, 11 P. U. R. (N.S.) 119 (D. C. P. U. C., 1935).

Idaho.

Boise Artesian Water Co. v. Public Utilities Commission, 236 Pac. 525, P. U. R. 1926A, 195 (Idaho, 1925).

The Commission excluded overheads from the rate base because there was no evidence that they had actually been expended. The Court reversed, saying:

"The value of a property is not necessarily its cost. Even though constructed economically, the construction cost is a mere evidence of value. The fact, even if it be admitted, that the system was largely built from profits, would not deprive the owner of his right to have the property given its present fair value. And ordinarily, even though the system was built up gradually and out of the profits of the company, and conceding that there is no evidence that any sum was ever actually expended for overheads, we do know that there is a value in the completed property in addition to the mere

naked cost of labor and materials necessarily used in its construction." (pp. 529-530)

Illinois.

Illinois Commerce Commission v. Chicago Telephone Company, P. U. R. 1924A, 213 (Ill. C. C. 1923).

In holding that original cost could not be ascertained entirely from a consideration of book value, the Commission said:

> "Furthermore, it appears that the book value now includes some overhead charges but that others have not been properly charged thereto. There is evidence of record to indicate that some costs of an overhead nature have previously been charged to operating accounts instead of to plant account. While this is an erroneous procedure it does not warrant the Commission in eliminating them from consideration when finding the original cost of the existing property." (p. 226)

Indiana.

Re Indianapolis Water Company, P. U. R. 1917E, 556, 612 (Ind. P. S. C. 1917).

Maine.

Rich v. Biddeford & Saco Water Company, P. U. R. 1917C, 982, 999 (Me. P. U. C. 1917).

Missouri.

City of Jefferson v. Capital City Water Company, 27 P. U. R. (N. S.) 69 (Mo. P. S. C. 1938).

> "The city objects to the inclusion of this item [construction overheads] in the estimated original cost on the ground that it was not an actual or recorded cost item, and if it had been incurred, it had previously been charged to operating expenses."

> "(1) We are endeavoring to arrive at a proper amount for the estimated original cost of the property as one of the elements to be considered in arriving at present fair value. This being true, the disposition of costs in the accounts of the company are immaterial. If the en-

tire costs of the property had been charged to operating expenses, we would still be obliged, to arrive at a figure for the estimated original cost." (p. 74)

New York.

People ex rel. New York State Rys. v. Public Service Commission, 202 App. Div. 576, 195 N. Y. Supp. 174, P. U. R. 1922E, 675 (3d Dept. 1922).

"With the exception above noted, the commission disallowed these items [overheads], because:

'Otherwise it would be necessary to revise the operating expense accounts by excluding a portion of the salaries of the officials concerned, and such revision would produce larger net earnings.'

"The 'larger net earnings' thus produced would relate to the period when the particular portion of the road under consideration was being organized, constructed, and developed, and would in no way affect present net earnings. It has been held that past losses are not to be considered in determining the rate base and whether the present rate is confiscatory.' *Galveston Electric Co. v. City of Galveston,* 257 U. S. ..., 42 Sup. Ct. 351, 66 L. Ed. ... (decided April 10, 1922); *City of Knoxville v. Knoxville Water Co.,* 212 U. S. 1, 14, 29 Sup. Ct. 148, 53 L. Ed. 371. It would seem to follow as a necessary corollary that, if past losses may not be considered in fixing a rate base, neither should past profits be so considered, nor what would have been past profits or 'larger net earnings' by a readjustment of operating expenses.

"We think, therefore, the commission has proceeded on an erroneous principle in excluding these overhead expenses." (p. 176)

Village of Wellsville v. Maltbie, 257 App. Div. 746, 15 N. Y. Supp. (2d) 580, 32 P. U. R. (N. S.) 436 (3d Dept., 1939).

Village of Boonville v. Maltbie, 245 App. Div. 468, 283 N. Y. Supp. 460, 466-467, 14 P. U. R. (N. S.) 93 (3d Dept. 1935), affirmed 4 N. E. (2d) 209 (N. Y., 1936).

New Rochelle Water Co. v. Maltbie, 248 App. Div. 66, 289 N. Y. Supp. 388, 397, 15 P. U. R. (N. S.) 32 (3d Dept. 1936).

Pennsylvania.

City of Erie v. Public Service Commission, 123 Atl. 471, P. U. R. 1924D, 89 (Pa. 1924).

"Time has usually wiped out much of the evidence to show original cost. The records then kept did not account for all the various items entering into it, nor do the books of today, though kept with meticulous care, exactly cover such items. As stated by Mr. Justice Brandeis in his concurrence in the *Southwestern Bell Case,* wherein the present value method is assailed in what may be termed the last word on the subject:

" 'Ordinarily, stocks and bonds did not indicate the amount of capital embarked in the enterprise. Depreciation accounts were unknown, and * * * book values or property accounts furnished no trustworthy evidence either of cost or of real value.'

"It is here that a part of the difficulty is met, if original cost were adopted as the rule of value. * * *." (p. 475)

Borough of Verona v. Suburban Water Company, P. U. R. 1920F, 942 (Pa. P. S. C., 1920).

"Original cost, one of the elements to be considered by the Commission in determining fair value, is the actual cost of the property. Historical cost may be defined to be the cost ascertained by applying to the property of the company the prices prevailing at the time the plant was constructed or property acquired. It is only ascertained when original cost is not available. Historical cost, therefore, may be more or less than original cost and neither should be confused with fair value, as they are only elements ascertainable in the manner indicated, to be considered by the Commission in reaching its determination. The cost submitted to the Commission in this case was original cost, so far as it was obtainable from the books of the company, and where original cost could not be obtained it was supplemented

by historical cost. It is, therefore, a combination of the two. Book value is that which is placed upon the property of the company for accounting purposes. It may be the same or more or less than original or historical cost." (p. 945)

Re Philadelphia Rapid Transit Company, 26 P. U. R. (N. S.) 65, 105 (Pa. P. U. C., 1938).

Wisconsin.

Re City of Milwaukee, P. U. R. 1927B, 229, 244 (Wis. R. R. C., 1926).

APPENDIX C.

Analysis of Cases Cited in Commission's Brief (Pages 79-82) Said to "Prohibit Reaccounting and Support the Principles Employed by the Commission" in Determining "Original Cost."

The only three federal cases cited on this point in the Commission's brief not merely for comparison ("Cf.") are the decision of the Supreme Court in the *Natural Gas Pipeline* case, the decision of the District Court in the *Los Angeles Gas & Electric* case, and the decision of the Circuit Court of Appeals for the Ninth Circuit in the *Northwestern Electric* case. As to these three cases we note the following:

1. *Federal Power Commission v. Natural Gas Pipeline Company*, 315 U. S. 575. Here the rate base actually used by the Commission was the reproduction cost new of all of the utility's physical properties, plus the present value of its gas reserves, its estimated capital additions, and working capital (315 U. S., 586-587). The discussion at page 590, specifically referred to in the Commission's brief, deals with the claim for $8,500,000 for going concern value as a separate allowance. There was no exclusion from the rate base in this case of any part of the cost or value of any items of physical property by reason of the past accounting practices of the utility. In excluding a separate allowance for going concern value, the Court pointed out that the only items excluded were "expenditures for securing new business" and costs of carrying "non-productive capacity" (315 U. S., 588).

2. *Los Angeles Gas & Electric Corp. v. Railroad Commission*, 58 F. (2d) 256 (D. Ct., S. D. Calif. 1932). This is the case that ultimately reached the Supreme Court in *Los Angeles Gas & Electric Corp. v. Railroad Commission of California*, 289 U. S. 287. The rate base found non-confiscatory by the Supreme Court was one of $65,500,000,

undepreciated, "on the basis of fair value." This was almost $5,000,000 in excess of historical cost (289 U. S., 310). The views of the California Commission and the District Court as to whether overheads in excess of those actually capitalized should under the particular circumstances of that case be included in the historical cost, the Supreme Court did not pass upon, pointing out that even if the $2,000,000 claimed by the utility had been added to the historical cost allowed by the Commission the result would still be substantially below the Commission's "fair value" rate base (289 U. S., 309-310).

The decision of the District Court that there should not be included in historical cost larger overheads than the utility had capitalized was based upon the principles of estoppel. In the initial valuation proceeding for this company in 1917, *Los Angeles Gas & Electric Corp.*, P. U. R. 1917 F, 717 (1917), the California Commission capitalized and included in the rate base overheads at approximately the 24.27% claimed by the company fifteen years later in the rate proceeding which finally reached the Supreme Court (P. U. R. 1931A, 132 (1930); P. U. R. 1933E, 317 (1933)). Thus, to use its own language, the Commission apprised the company that it could capitalize overheads at a substantial figure, even though part of them had been carried as operating expenses. The company, however, rejected the Commission's suggestion, and continued to capitalize overheads at slightly less than 6%, charging the balance to operating expenses. In this manner the company over a period of some fifteen years after the initial valuation and *in a succession of almost biennial rate hearings obtained increased rates on the basis of the operating expenses shown by its books, including the overheads* which the Commission had originally suggested that it might capitalize. Thus the company was actually *allowed* increased rates to take care of the enhanced operating expenses due to the overhead items it later sought to capitalize.

3. *Northwestern Electric Co. v. Federal Power Commission,* 125 F. (2d) 882 (C. C. A. 9th, 1942). This is a pure accounting case. The Federal Power Commission had ordered the utility not to place certain interest during construction in its capital accounts on its books, and the court held that the Commission was within its jurisdiction in requiring it so to account. The court was careful to point out (at p. 886) that "the system of accounts takes nothing from petitioner."

The two federal cases marked "Cf." in the Commission's brief are not relevant. *Helvering v. Wilshire Oil Company.* 308 U. S. 90, at pages 95, 97, was an income tax case in which the taxpayer sought both to deduct development costs from gross revenues in order to determine taxable net income and not to deduct them for the purpose of computing the depletion allowances. *Chicago & N. W. R. Co. v. Commissioner,* 114 F. (2d) 882, 886 (C. C. A. 7th, 1940), was also an income tax case, involving the right of the taxpayer to shift from the retirement to the straight line method of computing depreciation without complying with relevant regulations.

As to the two state court cases cited we note the following:

1. *Peoples Gas Light & Coke Company v. Slattery,* 373 Ill. 31, 25 N. E. (2d) 482, 493 (1940), app. dism. 309 U. S. 634, was a case in which the commission and court approved a rate base of $120,000,000 as against the historical cost (undepreciated) of the property as claimed by the company of $111,000,000. The case furthermore involves the application of the principle of estoppel since the utility had long been under regulation and had obtained higher rates by reason of the increased operating expenses due to the inclusion of the overheads which the company sought to capitalize.

2. *Natural Gas Company of West Virginia v. Public Service Commission*, 95 W. Va. 557, 121 S. E. 716 (1924). In this case the court disapproved the inclusion in the rate base of overheads and well drilling costs formerly charged to operations by means of which the company had obtained higher rates from the state commission. The court expressly approved the fair value rule for the fixing of a rate base and remanded the case to the Commission for its failure to give proper consideration to reproduction cost. In order to test the company's claim of confiscation, the court reconstructed a hypothetical rate base in which it added 52% to the historical cost of the company's property to determine its current fair value. The company claimed an allowance of 18% for overheads which the court found was not supported by the facts; but the court directed the commission on remand to make proper allowance for overhead costs.

In addition to the foregoing federal and state court cases the Commission's brief cites decisions by various commissions. Only three of these are by federal commissions. Two are the Federal Power Commission's own decisions. The *Canadian River Gas* case (43 P. U. R. (N. S.) 205 (1942)) is a rate case decided by the Commission shortly before the *Hope* case, and it applied exactly the same theories being tested here, but to a new property. The *Northwestern Electric* case (36 P. U. R. (N. S.) 202 (1940)), reviewed by the Circuit Court of Appeals in the opinion previously discussed, is a case involving the Commission's application to purely-accounting problems of its own interpretation of its system of accounts.

In addition the decision of the Interstate Commerce Commission in the *Elgin, Joliet & Eastern Railway Company* case is cited (84 I. C. C. 587 (1924)). What this case actually holds is that capital costs formerly charged to operating expenses, when properly identifiable, should be transferred to capital account for the purpose of determin-

ing the actual original cost of a railroad property. As we noted in Appendix B at pages 166 to 168 above the Interstate Commerce Commission has uniformly taken this position and as the oldest federal regulatory body its interpretation of what is meant by the term "original cost" is of controlling significance.

The balance of the cases cited in the Commission's brief are all State commission cases which fall into one or more of the following general classes:

1. Cases where the rate base fixed was present fair value, substantially in excess of the depreciated original or historical cost of the property.

California:

San Francisco v. Pacific Gas & E. Co., P. U. R. 1918A, 506 (1917) also cited in classes 2 and 4.

District of Columbia:

Re Potomac Electric Power Co., P. U. R. 1917D, 563 (1917) also cited in class 2.

Hawaii:

Re Hawaiian Electric Co. Ltd., 33 P. U. R. (N. S.) 161 (1940).

Illinois:

Illinois Commerce Comm. v. Pub. Serv. Co., 4 P. U. R. (N. S.) 1 (1934) also cited in class 2.

Illinois Commerce Commission v. Commonwealth Edison Co., 15 P. U. R. (N. S.) 404 (1936) also cited in class 2.

Indiana:

Re Indianapolis Water Co., P. U. R. 1919A, 448 (1918).

Michigan:

Re Eaton Rapids, P. U. R. 1922D, 94 (1922).

Missouri:

Re West St. Louis Water & Light Co., P. U. R. 1922E, 805 (1922) also cited in class 3.

Aluminum Goods Mfg. Co. v. Laclede Gas Light Co., P. U. R. 1927B, 1 (1926) also cited in class 4.

New York:

Re Brooklyn Borough Gas Co., 21 P. U. R. (N. S.) 353 (1937) also cited in classes 2 and 3.

Herman v. Newtown Gas Co., P. U. R. 1916D, 825 (1916).

Maires v. Flatbush Gas Co., P. U. R. 1920E, 930 (1918) also cited in class 2.

Moritz v. Edison Electric Illum. Co., P. U. R. 1917A, 364 (1916) also cited in class 2.

Pennsylvania:

Public Utility Comm. v. Duquesne Light Co., 20 P. U. R. (N. S.) 1 (1937).

West Virginia:

Re Clarksburg Light & Heat Co., P. U. R. 1928B, 290 (1927) also cited in class 2.

Re West Virginia Central Gas Co., P. U. R. 1924E, 24.

Re West Virginia Central Gas Co., P. U. R. 1918C, 453 also cited in class 3.

Re Clarksburg Light & Heat Co., P. U. R. 1917A, 577 (1916) also cited in class 4.

Wisconsin:

Re Reedsburg Telephone Company, 7 P. U. R. (N. S.) 389 (1934).

2. Estoppel cases where the circumstances were similar to those in the Los Angeles case.

California:

San Francisco v. Pacific Gas & E. Co., P. U. R. 1918A, 506 (1917) (Municipal Regulation) also cited in classes 1 and 4.

Re Los Angeles Gas & Electric Corp., P. U. R. 1931A, 132 (1930) (Commission decision under review in *Los Angeles* case above. Commission included interest during construction not previously capitalized).

Re Los Angeles Gas & Electric Corp., P. U. R. 1933E, 317 (1933) (Accounting case).

District of Columbia:

Re Potomac Electric Power Co., P. U. R. 1917D, 563 (1917) (Congressional Regulation) also cited in class 1.

Illinois:

Illinois Commerce Comm. v. Pub. Serv. Comm., 4 P. U. R. (N. S.) 1 (1934) also cited in class 1.

Illinois Commerce Comm. v. Commonwealth Edison Co., 15 P. U. R. (N. S.) 404 (1936) also cited in class 1.

New York:

Moritz v. Edison Electric Illum. Co., P. U. R. 1917A, 364 (1917) also cited in class 1.

Maires v. Flatbush Gas Co., P. U. R. 1920E, 930 (1918) also cited in class 1.

Re New York State Railways, P. U. R. 1922B, 75 (1921).

Re Westchester Lighting Company, 15 P. U. R. (N. S.) 299 (1936).

Re Brooklyn Borough Gas Co., 21 P. U. R. (N. S.) 353 (1937) also cited in classes 1 and 3.

Pennsylvania:

Public Utility Com. v. Peoples Natural Gas Co., 43 P. U. R. (N. S.) 82 (1942).

West Virginia:

Re Clarksburg Light & Heat Co., P. U. R. 1928B, 290 (1927). (Where well drilling costs were being charged to expense, Commission said they "should not be included in the present valuation of its property, *provided the same policy of accounting is continued.*" p. 297) also cited in class 1.

Wisconsin:

Re Mondovi Telephone Co., P. U. R. 1933B, 319 (1932); P. U. R. 1933D, 142 (1932).

3. Cases where the items excluded from the rate base comprised for the most part intangible overheads and not direct property costs and the claims for such overheads were wholly unsupported by the facts:

Missouri:

Re West St. Louis Water & Light Co., P. U. R. 1922E, 805 (1922) (Contractor's fee) also cited in class 1.

New York:

Re Brooklyn Borough Gas Co., 21 P. U. R. (N. S.) 353 (1937) also cited in classes 1 and 2.

West Virginia:

Re West Virginia Central Gas Co., P. U. R. 1918C, 453 (1918) (20%) also cited in class 1.

4. Cases where the items excluded from the rate base were not proper capital costs but were regarded as current operating expenses:

California:

San Francisco v. Pacific Gas & E. Co., P. U. R. 1918A, 506 (1917) (expense involved in location of street lamps) also cited in classes 1 and 2.

Colorado:

Re Leadville Water Co., P. U. R. 1921D, 172 (1921).

Idaho:

Re Kootenai Power Co., P. U. R. 1924E, 831 (1924) (Donations, advertising, etc.).

Missouri:

Aluminum Goods Mfg. Co. v. Laclede Gas Light Co., P. U. R. 1927B, 1 (1926) (Cost of records) also cited in class 1.

Montana:

Public Service Commission v. Montana Petroleum Company, P. U. R. 1924B, 364 (1923).

West Virginia:

Re Clarksburg Light & Heat Co., P. U. R. 1917A, 577 (1916) (Drilling costs excluded because treated as operating expenses by Commission for future) also cited in class 1.

The only case cited by the Commission which is not included in any of the foregoing categories is *Re Central Maine Power Co.,* P. U. R. 1918C, 792 (1918), which was not a rate case at all but involved simply the authorization of the issuance of securities.

As a matter of fact, many of the cases cited by the Commission expressly permit the inclusion of overheads not previously carried in capital account or expressly approve the inclusion in the rate base of property purchased from income, including the following cases:

California:

San Francisco v. Pacific Gas & E. Co., P. U. R. 1918A, 506 (1917) (10% for overheads; see also page 519).

Michigan:

Re Eaton Rapids, P. U. R. 1922D, 94 (1922) ($31,000 acquired from profits as against $185,000 rate base).

Missouri:

Aluminum Goods Manufacturing Company v. Laclede Gas Light Co., P. U. R. 1927B, 1 (1926) (15% for overheads and also donated property included).

Montana:

Public Service Commission v. Montana Petroleum Company, P. U. R. 1924B, 364 (1923) (20% for overheads).

West Virginia:

Re West Virginia Central Gas Co., P. U. R. 1918C, 453 (1918).

Re West Virginia Central Gas Co., P. U. R. 1924E, 24 (1924).

APPENDIX D.

HOPE NATURAL GAS COMPANY

"Direct Costs of Production of Gas (Exclusive of Return) and Increment of Direct Costs Year 1940 Over 1939."

[Copy of Table 12 of Cleveland Reply Brief before the Commission (p. 104)]

	Exhibit 67, 1939	Exhibit 78, 1940	Increment Costs—1940 over 1939
Expenses of Producing Gas, Excl. of eciation and Depletion (Ex. 67, pp. 17, Ex. 78, pp. 17, 23)			
4.1 Gas Well Labor	$ 330,338.52	$ 347,147.21	
5.1 Gas Well Supplies and Expenses	130,999.56	164,662.01	
1 Maint. of Prod. Gas Well Equip.	53,457.92	83,242.02	
5 Gas Well Royalties	828,851.62	885,841.27	
Total Direct Gas Well Expenses	1,343,647.62	1,480,892.51	
oss Production Tax	144,633.15	221,908.58	
Total, Incl. Production Tax	1,488,280.77	1,702,801.09	
eciation and Depletion (Ex. 78, p. 54)			
perated Acreage	$ 36,772.47	$ 57,084.00	
as Well Construction	182,755.43	286,492.00	
ost of Abandoning	69,813.58	105,860.00	
Total Depletion	289,341.48	449,436.00	
epreciation of Gas Well Equipment (Ex. 61, p. 24; Ex. 78, p. 26)	188,482.85	186,702.97	
Total Depreciation and Depletion	$ 447,824.33	$ 636,138.97	
olume of Gas Produced—M.c.f. (Ex. 78, p. 54)	16,546,230	26,800,000	10,253,770
et Expenses per M.c.f. Produced			
34.1 Gas Well Labor	2.00¢	1.29¢	
35.1 Gas Well Supplies and Expenses	.79	.61	
41 Maint. of Prod. Gas Well Equip.	.32	.31	
45 Gas Well Royalties	5.01	3.31	
Total Direct Gas Well Expenses	8.12	5.52	
Gross Production Tax	.87	.83	
Total, Incl. Production Tax	8.99¢	6.35¢	
reciation and Depletion per M.c.f. Proeed:			
Depletion	1.75¢	1.68¢	
Depreciation of Gas Well Equipment	1.14	.70	
Total Depreciation and Depletion	2.89¢	2.38¢	
al Direct Costs of Producing Gas, Incl. epreciation and Depletion:			
Amount	$1,966,105.10	$2,338,940.06	$372,834.96
Per M.c.f. Produced	11.88¢	8.73¢	3.64¢"

APPENDIX E.

HOPE NATURAL GAS COMPANY.

Indicated Rate Reduction Based on Findings of the Commission for the Year 1940 and Reported Changes in Plant, Revenues, and Expenses to December 31, 1942.

(Excluding former Reserve Gas Company Operations)

	1940 per Commission Findings (R. I, 12)	Increase on Commission's Method	1942	Less former Reserve Gas Company (Ex. 77)	1942 excluding former Reserve Gas Company
	(1)	(2)	(3)	(4)	(5)
Operating Revenues from Interstate Sales	$19,296,755	$5,933,028	$25,229,783	$1,210,973	$24,018,810
Operating Deductions:					
Operating Expenses except Federal Income Tax	12,997,845	4,452,813	17,450,658	716,942	16,733,716
Federal Income Tax	912,313	1,627,704	2,540,017	71,207	2,468,810
Total	$13,910,158	$6,080,517	$19,990,675	$ 788,149	$19,202,526
Net Operating Revenues from Interstate Sales	5,386,597	(147,489)	5,239,108	422,824	4,816,284
Return at 6½%	2,088,756	231,976	2,320,732	(Note A)	2,320,732
Excess Earnings before Income Tax Saving	3,297,841	(379,465)	2,918,376	—	2,495,552
Income Tax Savings	912,313	1,033,271	1,945,584	—	1,663,701
Total Indicated Rate Reduction	$ 4,210,154	$ 653,806	$ 4,863,960	—	$ 4,159,253

NOTE A: No adjustment of the 1942 return computed by the Commission's brief is made since there is no way of determining what if any amount is included therein on account of the Reserve Gas Company's properties. The $3,377,171 net addition to the average 1938-1939 rate base used by the Commission's brief in computing the return would include at the most the very low net book cost of the Reserve properties, a 6½% return on which would be less than $150,000.

( ) Parentheses denote losses.